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Autorité fédérale de surveillance des marchés financiers FINMA
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“Action is now needed on investment property”

Ladies and gentlemen

The financial sector has been facing an extremely challenging environment for some time now. I am referring here primarily to the low interest rate environment. The low interest rate environment affects a broad chunk of finance from retail banking to life insurance to the savings process in general. I don’t think it is too blunt to say that the low interest rate environment poses risks to financial stability. The margin between borrowing and lending is the core of the banking business. Net interest margins have fallen sharply. That is why so many banks, particularly in Europe, are struggling with their profitability. However, my talk today is not going to be about the direct impact of the low interest rate environment. Instead I want to look at the property market and in particular at mortgage lending. This issue is interlinked with the low interest rate environment and the phenomenon of the “reach for yield” it has brought about. As financial market supervisors we have been concerned about the risks to the financial sector deriving from the mortgage market for some time.

The Swiss real estate market is too big to fail

The Swiss real estate market has witnessed strong growth in recent years due to exceptionally low interest rates and other factors such as robust economic growth and immigration. The mortgage lending market has grown very sharply in parallel with the real estate market. Total mortgage lending currently stands at over CHF 1 trillion.

Over a trillion Swiss francs? That is significantly more than Switzerland’s annual economic output, which currently amounts to CHF 670 billion. One trillion Swiss francs also equates to around 120,000 francs per head for every Swiss citizen – man, woman and child. The mortgage market can therefore be described without exaggeration as “too big to fail”. Growth in mortgage lending has outstripped economic growth and growth in incomes for some time. This is one of the reasons why, as a proportion of GDP, Switzerland has the highest level of household debt in the world. But not only is the volume of mortgage loans extremely high, it has also grown rapidly: by 45% in the last decade and by 100% over the last 15 years.

We are therefore monitoring this market in Switzerland very closely. This is not about pessimism or talking things down, as real estate crises have sadly recurred at regular intervals in the past. Moreover, when they occur they have a very serious impact on the financial institutions and economies concerned. The obvious recent example is the subprime crisis in the US, Spain and Ireland. But we don’t even need to look abroad: in Switzerland the bursting of the real estate bubble in the 1990s also prompted a broader economic recession.

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In the rest of this talk I want to highlight where FINMA currently sees the biggest risks in the mortgage market, where it can intervene effectively as a supervisory authority and what other measures it regards as necessary to strengthen stability and sustainability in the real estate sector.

Role and importance of different players on the real estate market

Anyone who talks to supervised entities about their lending behaviour is often told that while they have the risks in this cut-throat market under control, many of “the others” are fuelling the market. Banks, insurers, real estate funds, pension funds and new providers such as crowdfunding platforms are all watching both their competitors and rival industries with suspicion. One of the main concerns voiced by market players is the need for a level playing field. This is understandable. No-one wants regulation to lead to a distortion of competition. It will continue to be a priority for FINMA to avoid this in the areas we supervise.

The financial institutions on the real estate market play a number of different roles:

- They act as lenders, i.e. they provide debt for real estate;
- They are active on the real estate market as investors;
- They enable investors to participate in real estate, for example in the form of funds.

Let’s take the insurers for example. They are among the non-banks who engage in all three of the roles listed above. Insurers act both as investors and as mortgage lenders on the real estate market. And a number of insurers also turn parts of their portfolio into real estate funds. FINMA takes account of the specific risks associated with these roles in its supervision, in other words we differentiate between credit risk and investment risk.

But how big a weight do insurers have on the market? In terms of mortgage lending they account for 4% of loans. Together with the other smaller market players, i.e. the pension funds and other lenders such as crowdfunding companies etc. they make up less than 6% of all lending. The banks are responsible for the remainder of the outstanding mortgage loans of over CHF 1 trillion currently. They provide most of the debt for real estate in Switzerland and therefore have the overwhelming proportion of the credit risk. But although the insurers finance less than 5% of the real estate in Switzerland, some insurers get close to the maximum limit of 35% of their investment portfolio that can be held in real estate and mortgages. Therefore the question is not so much how important the insurers are for the real estate market, but rather how important the real estate market is for insurers. Risky investments at overblown prices could easily weaken insurers’ solvency. That is why FINMA carries out annual surveys of the insurers’ real estate portfolios and sometimes demands additional capital, e.g. if we identify concentrated risks in individual regions. FINMA also conducts stress tests to understand the impact of a real estate crisis on insurers’ solvency and onsite reviews of how the insurers value real estate.

The banks and the mortgage market: strong growth

Let us now turn to the banks. The interest rate environment been challenging for banks in recent years. Net interest margins, the principal source of revenues for retail banks, have shrunk. To keep revenues stable, banks have therefore had an incentive to increase their lending volumes and/or take greater risks. FINMA has therefore been monitoring mortgage lending extremely closely for years. Last

year we carried out onsite reviews of mortgage lending at 13 banks. Our focus has evolved: in the past FINMA tended to focus primarily on lending for owner-occupied properties due to high growth rates in this segment. But lending growth to owner-occupied properties has slowed somewhat, not least due to the tightening-up of self-regulation in 2012 and 2014 and the associated stricter rules, e.g. on amortisation and withdrawals of provision assets.

Elevated risks in investment property

Meanwhile the growth in investment property, defined as properties which are not occupied, or not only occupied, by the borrower, remains as strong as ever. FINMA is currently focusing its supervision on this part of the market. The prices of buy-to-let properties have spiked to another all-time high. Owing to continued low interest rates, at the moment there are not many supposedly low-risk investments that offer a reasonable yield. In the eyes of investors, investing in real estate therefore still looks relatively attractive. However, rising prices for investment properties could lead to a considerable imbalance on the market, as we are observing stagnating rents and increasing vacancies in parallel with rising prices. The figure for vacant residential units published by the Swiss Federal Statistical Office reached its highest level ever in mid-2018 at over 70,000. To put this in perspective, imagine a ghost town of about the same size as Berne or Lausanne, or the entire canton of Schwyz with every single home empty. However, these vacancies are growing at a time when construction activity remains strong. The result is an oversupply of homes. Given the fall in net immigration, the only way this oversupply could be absorbed regionally would be if there was an economic boom.

The current environment of high prices and rising vacancies greatly increases the risk of price corrections and loan defaults. Both market observation and analysis and our own supervisory work has highlighted this for some time. We have been warning of the risks since 2014, i.e. for five years, both in our discussions with individual banks and other players in the sector, as well as publicly.

It is certainly true that FINMA can take supervisory action to deal with individual high risk institutions. However, supervisory action of this kind only has an indirect impact on the overall quantum of risk. Taking action against individual institutions in the current environment is a bit like a game of “whack a mole”. Like a labour of Sisyphus, no sooner has one mole been knocked on the head, than a new one pops up somewhere else. This kind of action is backward-looking and corrective, but not preventive, and would lead to supervisors remaining stuck behind the curve.

FINMA is currently imposing capital charges for increased risks in the mortgage market on a number of banks. It has also laid down multipliers for mortgage lending for various institutions who use internal models to determine their capital requirements. As a result of this action additional capital charges totalling over CHF 4 billion have been applied to eleven banks.

The stress test we carried out simultaneously at 18 banks in the fourth quarter of 2018 confirmed that investment property should be the focus of our supervisory work. We have been conducting such stress tests regularly since 2012. The more extreme of the two stress scenarios is always based on the Swiss real estate crisis of the 1990s. Stress tests are about identifying trends, not about precise forecasts of how likely the tested scenarios are. The aim of stress testing is ultimately to identify institutions with elevated risks to enable action to be taken on these banks if necessary.

So what were the most important results of the stress test we carried out year?

- On average the banks' risk profile has deteriorated compared to the previous tests carried out between 2012 and 2017, which means that the loss ratios for the same negative scenarios are higher than in previous years.
- The risks have generally shifted from owner-occupied residential property to investment property. Over 70% of the expected losses were incurred in the investment property portfolio, although this only accounted for 29% of total mortgage lending in the sample.
- Around half of the banks would fall below their capital thresholds, in some cases by a wide margin, and would have to raise fresh capital.

Authorities keen to see adjustments to the regulatory framework

For some time we have believed that the signs of overheating in investment property can only be dealt with effectively by making changes to regulation or self-regulation, as has been achieved successfully in the owner-occupied mortgage lending segment. The International Monetary Fund (IMF) has also noted the scale and growth in mortgage-based debt in Switzerland and supports a tightening of the regulatory framework in this sector.

The aim of the measures must be to strengthen the banks' resilience to losses in the residential investment property segment. Tightening up the lending criteria – e.g. loan-to-value ratios and amortisation – would be a particularly effective way of achieving this. Effective adjustments to banks' self-regulation would be very welcome.

The alternative would be to raise the capital requirements for investment property in the Capital Adequacy Ordinance. In particular, loans for investment properties with an LTV of over two thirds would attract more stringent requirements. This stricter risk weighting is in line with the latest international standards and takes appropriate account of the fact that residential investment properties are higher risk than owner-occupied properties.

Conclusion

The mortgage market is critical to the stability of the Swiss financial centre. It is too big to fail. All too often crises on the mortgage market have had serious consequences for the stability of national economies, as has been the case in Switzerland in the past. That is why FINMA wants to see sustainable mortgage lending. We intervene when individual institutions take on excessive risks, but we believe this is not enough to counteract the generalised overheating trends we are currently seeing. As a result action is needed now. Whether through regulation or self-regulation, this must have a genuinely across-the-board impact. It is in everyone's interest to strengthen stability and sustainability in the real estate and mortgage markets.