

Basel III: Higher construction costs due to stricter requirements - a critical analysis

Dr. Roger Stettler & Thomas Hilpert, April 2025

The final Basel III regulations came into effect in Switzerland on January 1, while their implementation in the USA, the EU, and the UK remains uncertain or delayed. As a result, banks in Switzerland are adopting a more cautious approach, making it more challenging to finance new construction projects. A new market equilibrium is expected, but with significantly higher construction costs.

Noble Goals

The final Basel III framework is a comprehensive reform package aimed at strengthening the solvency and liquidity of banks. According to the Swiss Federal Council on June 26, 2024, high-risk activities will require more capital, while lower-risk ones will require less. From the outset, the intention was to coordinate implementation globally to avoid competitive disadvantages for internationally active banks. In Switzerland, this primarily concerns UBS.¹

The impact of the adjustments on owner-occupied residential property is minimal—in fact, capital requirements in this area are even lower. However, the effects on

construction projects are significant. This is due to several factors, chief among them concerns about the methodology used to determine the capital requirements.

A Monoculture in Methodology

In Switzerland, there is a lack of diversity in credit risk assessment methodologies that



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can be used by banks due to regulatory constraints. Evaluations are based on rigid criteria such as ‘affordability’ and ‘loan-to-value’ ratios. Other factors, such as the market liquidity of real estate, have little influence on the permitted loan amount. Banks also remain inflexible when it comes to affordability assessments: modern forms of employment, such as self-employment or project-based work, are not adequately taken into account.

In the last three decades, there have been hardly any loan defaults in the mortgage

¹ SWI swissinfo.ch from 26.6.24

business in Switzerland. The few actual credit losses mainly relate to clearly defined areas:

- Cases of fraud, e.g. due to misrepresentation of rental income or floor space.
- Structural change and the associated decline in the attractiveness of certain real estate classes.
- Bankruptcies of general and total contractors.
- Luxury or collector's assets with low marketability.
- Special situations such as unfavorable building lease agreements, value-reducing easements or structural defects.
- Loss of income due to strokes of fate (illness, divorce, death) in combination with an unfavorable market situation.

How should an institution or a regulator react to this low number of defaults?

"Structural policy is not part of the regulator's or a bank's remit"

Fraud cases are notoriously difficult to combat. In addition, the question of cost arises. Given the extremely small number of such cases, we see no need for action. These matters are, in our view, more appropriately addressed as part of the due diligence process carried out by lending institutions.

The other cases are often the result of rigid rule-following, a lack of expertise, or insufficient oversight. In these instances,

empirical risk modeling and appropriate processes could help mitigate the risks.

Risks in Residential Construction

There is a broad consensus that Switzerland needs significantly more living space, especially in the metropolitan areas.² The risks involved in building apartments from the perspective of a bank and ultimately the regulator are as follows:

- Marketing risk: Is there sufficient demand for the apartments? Can buyers find financing for their purchase?
- Project/implementation risk: Can the project be completed on time, within budget, and with an acceptable level of quality?

These risks are not purely theoretical. In 2024, for example, a large number of property developer insolvencies were observed in Germany because demand for residential property fell, prices fell and construction costs rose sharply at the same time.

Cross-country comparisons are only of limited value in this context. Unlike in the USA and, to some extent, Germany, it is uncommon in Switzerland to build owner-occupied apartments "on stock" and sell them shortly before or after completion. Many developers only begin construction once at least half of the purchase agreements have been notarized, down payments made, and the units legally sold. This approach reduces the marketing risk to nearly zero.

² [Housing shortage in Switzerland: an overview - Die Volkswirtschaft](#)

In Switzerland, the rare issues that do arise are mainly related to project risk—specifically, the failure of contractors or construction companies. Identifying and mitigating these risks—for example, through effective construction cost control and careful vetting of partners—is one of the banks’ most important roles. So what impact does the final Basel III framework have on the business of construction projects?

Risk weighted assets

The percentages listed in the regulation refer to the required Risk-Weighted Assets (RWA), meaning risk-adjusted assets. As such, they indirectly indicate the actual amount of equity capital that must be held. The associated costs can be derived from standard equity capital costs.

In the case of residential property, the need for RWAs is decreasing slightly, so financing should become somewhat cheaper.

	Amount	RWA in %	RWA
Old	1.0 M	35	0.35 M
	0.2 M	75	0.15 M
			0.50 M
New	1.2 M	35	0.42 M
Delta			-16%

Fig. 1: Owner-occupied property, property value at 1.5 million, 80% loan-to-value = mortgage of CHF 1.2 million.

In contrast, residential investment properties with a loan-to-value (LTV) of over 60%, for example, are more expensive to finance.

The hardest hit are land acquisition loans and construction credits, which must be backed with Risk-Weighted Assets (RWA) amounting to 150% of the loan amount.

	Amount	RWA in %	RWA
Old	3.96 M	35	1.386 M
	0.54 M	75	0.405 M
			1.791 M
New	4.50 M	150	6.750 M
Delta			276%

Fig. 2: Residential construction project, property value 6.0 million, 75% loan-to-value ratio = construction loan of CHF 4.5 million.

So what additional costs arise from the new standards for construction projects? Capital requirements amount to at least 8% of the risk-weighted assets (RWA). On top of this comes the countercyclical capital buffer of 2.5%, which is intended to address systemic risks, as well as potentially institution-specific surcharges (not considered here). In the example above, an additional CHF 4,959,000 in RWA would need to be backed by 10.5% equity capital, amounting to just under CHF 520,000.

Assuming a typical industry target return on equity of 8% before taxes, this results in additional annual costs of CHF 41,600 for a loan of CHF 4.5 million—or approximately 92 basis points (0.92%). This represents roughly a doubling of the bank margins observed in recent years. At first glance, this should be manageable and could potentially be offset by lower land prices or higher sales prices.

Why do property developers struggle to secure financing, even when they’re willing to accept these additional costs? This brings us back to the issue described earlier: many banks still find it difficult to consistently apply risk-adjusted pricing and instead continue to rely primarily on binary yes/no decisions. Rather than moderately

and appropriately increasing prices, banks often choose not to issue loans at all when there's any uncertainty.

"Borrowing costs increase by around 1 percentage point for construction projects"

The economic consequences of this are significant. Construction activity is already well below the necessary level, and the more restrictive credit supply has had negative effects on developers looking to build in recent months. We are seeing strong demand at institutions that are still offering construction financing, which is leading to long processing times.

Alternative Sources of Capital

In addition to banks, property developers can turn to alternative sources of capital such as mezzanine financing, which can also be used to complement bank loans. While more expensive, these options can still enable projects to move forward despite credit rationing, thereby creating added value. Innovative approaches like profit-sharing models are sometimes hindered by tax-related barriers. Another option is greater upfront financing from property buyers—there are already market examples of this in practice.

Highly capitalized general contractors could increasingly rely on equity financing in the future. However, from a capital efficiency perspective, this presents other challenges and would ultimately lead to a decline in construction activity.

Conclusion

The artificial increase in credit costs must be called into question, as it weakens the supply of housing. Regulation should be based on clearly quantifiable problems—yet historical data suggests otherwise. In Switzerland in particular, where defaults on construction financing are minimal, further tightening appears questionable. Meanwhile, riskier markets—with significantly higher default rates and more fragile market structures (e.g., no pre-sales)—often refrain from such measures.

Beyond the lack of diversity in credit assessment methodologies, overly narrow regulations also lead to a centralization of responsibility with the regulator. A financial system that does not permit a diversity of approaches lacks resilience in times of crisis. A broader range of methods and frameworks would be far more effective.

Construction projects are of critical macroeconomic importance—banks should not withhold financing out of caution alone, and they should offer appropriately adjusted prices. Basel III must not become an excuse. One way or another, alternative sources of financing will become increasingly important.

Hyrock is an independent mortgage and real estate expert for discerning private and institutional clients in Switzerland with offices in Zurich, Schindellegi and Geneva. In 2024, Hyrock realized a total of over CHF 1,031 million in financing solutions for its clients with an average loan amount of CHF 6.4 million per transaction. CHF 618 million of these were mezzanine and bridge loans. www.hyrock.ch