Credit risk assessment in Swiss real estate financing - away from monoculture

By Thomas Hilpert and Dr. Roger Stettler, 08.08.2023

Due to the low number of documented loan defaults, the risk measurement instruments used by lenders are very rudimentary. For further development, tools and methodologies developed abroad must be taken into consideration. The creation of high-quality tools is only possible if the regulator frees the mortgage market from its shackles and allows a market-based solution and a plurality of methods.

The Swiss mortgage market is the most important credit market in Switzerland and of enormous importance for domestic banks. The balance sheet position "mortgages" accounts for 70% - 85% of the assets of the typical retail bank.

Accordingly, the risk measurement of this position is central both to the financial health of the individual bank and to financial market stability.

Switzerland has experienced very few mortgage defaults in the last 20 years. These are often due to poor documentation by the lenders, which is also linked to the special measuring problems of loan defaults, especially in the case of owner-occupied properties: A default is typically preceded by a longer period of delayed interest payments, during which the borrower tries to avoid the default by making payments from his social environment. Similarly, defaults rarely lead to actual recovery: Both borrowers and lenders have an incentive to avoid public sale and are more likely to seek a discrete disposal of the collateral in the property market.

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Actual recoveries by the bankruptcy authorities in the last 20 years were mainly due to complicated personal situations (e.g. addictions, exceptional mental states due to divorce/separation, inheritance disputes, etc.). The explanatory powers of the few recoveries are also very limited, as the efficiency and professionalism of the offices responsible for the recovery vary.

This is why it is almost impossible in Switzerland to produce useful estimates of

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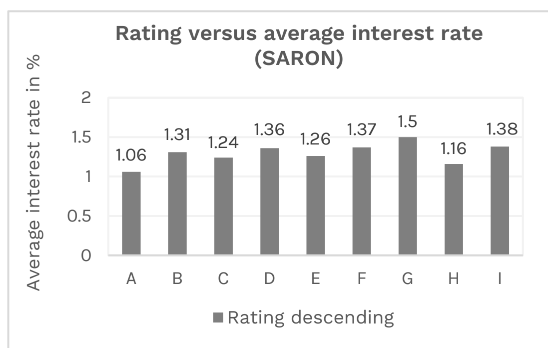
default rates over a credit cycle for the last 20 years or to evaluate reliable, general results based on actual default cases. The statistical tools used are often based on a comparatively tiny data set that is extrapolated. The predictive properties of such models are minimal, something that all parties involved are aware of.

In practice, lenders have rating systems. However, statistical analysis shows that for most lenders these rating systems are not or hardly used in pricing (see in Fig. 1: The SARON mortgage loan book of a medium-sized bank). In practice, credit approval still consists of a yes/no decision, and price negotiation with the customer is separate from this.

Figure 1: Evaluation of current mortgage book - prices do not correlate with rating



Affordability and loan-to-value

Today, the regulator relies heavily on two factors "affordability" and "loan-to-value ratio".

The affordability (see the box "affordability calculation" for details) measures the borrower's ability to service the loan, calculated on the basis of current or previous income, by means of general assumptions. In practice, this factor is the main reason for so-called "exceptions to policy" and thus becomes the biggest hurdle for the borrower in the loan approval process. At the same time, the affordability coefficient is also the factor for which there is no evidence from past financial crises that it correlates in any way with the probability of default.

Affordability calculation

The so-called "affordability" is intended to ensure the long-term financial ability to honor debts. For this purpose, the income of a borrower is compared to the imputed interest costs as well as other costs of the property.

There is no evidence that this instrument predicts default in any way. A borrower's default is virtually always preceded by a life event. This can be a divorce, a protracted illness or the loss of a job. As a result, the borrower's income changes significantly in a negative way: the former affordability calculation becomes a waste.

After the financial market crisis, this mechanism became particularly dramatic in countries with widespread mass unemployment and falling real wages, such as Ireland, Spain or Greece. Although interest rates and the burden of debt servicing on borrowers actually declined, lenders faced dramatic default rates because borrowers lost their well-paid jobs and were either unable to find a new job or only one that was significantly lower paid.

For example, a loss of employment usually precedes a loan default in the case of individuals. It is therefore simply nonsensical to use an affordability calculation in the risk assessment on the assumption of continued employment. Especially for people with very high incomes, who have no problems with the

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affordability calculation, the decline in income is particularly severe in the case of job loss.

In the case of investment properties, it is particularly noticeable that an affordability calculation for older properties in remote areas regularly produces unproblematic results, as such properties trade on the market at significantly higher gross yields. Especially for new, energy-efficient properties in very attractive locations, the affordability calculation regularly leads to possible loan-to-value ratios of up to 60% of the appraised value. Paradoxically, the current affordability rules encourage the financing of properties which, as experience shows, are difficult to sell in an economic downturn and for which liquidity is lower in a crisis.

The lower of cost or market principle

The so-called "lower of cost or market principle" is typically used for financing. This means that in the case of an acquisition, both the purchase price and the market price estimate are considered, and the lower value is used for the calculation of the loan-to-value ratio.

From an economic point of view, this approach makes little sense. A sales price is influenced by numerous factors - for example, the seller may prefer a particularly quick sale or may want to avoid broad marketing. A high-quality market price estimate normalizes these factors. Therefore, there is no reason not to use exclusively the valuation price of the bank-accredited trusted valuer or the bank's own property valuation model, unless there is no trust in the valuation method used - in which case it is better not to issue mortgages at all.

The loan-to-value ratio measures the relationship between the loan amount and the estimated market value of a property (appraised value). Depending on the type of property, the maximum loan-to-value ratio is between 60% and 80%. The main objective is to ensure that the property can be sold without loss of credit even if the market falls and the property is sold quickly.

The problem is that individual demand is not linked to the type of property, but rather to the depth and liquidity of a local property market for the specific property. A commercial property (typical maximum rental value of 65%) in an attractive location is usually much simpler and easier to sell than an owner-occupied single-family house (maximum rental value of 80%) in a peripheral region threatened by migration. This is particularly evident in the case of so-called "luxury properties": in an attractive villa area, such properties are no more difficult to sell than a "normal" single-family home. If, however, the otherwise identical property is located in a medium-sized municipality, a very lengthy and costly marketing process is regularly to be expected.

Making the maximum loan-to-value ratio dependent on a property type is thus clearly too static and leads to systematic market distortions.

Further development of the market

A fundamental further development of risk measurement in the Swiss mortgage market is only possible if the plurality of risk measurement instruments and ultimately the number of loan defaults increases. Possible instruments would be the following:

- The immediate repeal of the non-empirical "Guidelines for the examination, valuation and settlement of loans secured by real estate mortgages" without replacement[1]. Banks should develop their own (heterogeneous) risk measurement tools.
- Fundamental legal innovations, e.g. mortgage financing without personal liability of the borrower. In practice, this could lead to more loan defaults, which is desirable for the further development of credit models.
- Significant acceleration of sales processes by increasing efficiency. There is no reason why more than 12 months should elapse between a loan default and the execution of an auction. Faster sales would allow the LGD[2] ratio to be calculated more reliably.

Financial market stability through heterogeneity

Heterogeneous risk assessment methods and experience with loan defaults are more effective in enhancing financial market stability than impractical sustainability rules and/or rigid loan-to-value ratios. The Swiss mortgage market is so important for the local economy that a monoculture poses considerable inherent dangers.

Hyrock is an independent mortgage and real estate expert for sophisticated private and institutional clients in Switzerland at its locations in Zurich, Schindellegi and Geneva. In 2022, Hyrock implemented financing solutions for its clients totaling CHF 1,052 million with an average loan size of CHF 6.1 million per transaction. Thereof, CHF 287 million were mezzanine and bridge loans. www.hyrock.ch

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[1] Link: only in german: SBVg_Richtlinien_für_die_Prüfung_Bewertung_und_Abwicklung_grundpfandgesicherter_Kredite_DE.pdf (swissbanking.ch)

[2] Loss Given Default: The actual, average loss in the event of a loan default