

Intelligent Investment

# How potential SNB rate cuts could be offset by rising mortgage margins

## VIEWPOINT

The Swiss market might be overestimating the impact of interest rate cuts. We anticipate that interest margins of Swiss banks will continue to increase significantly, and at least partially offsetting potential future SNB rate cuts.

CBRE | CAPITAL ADVISORS  
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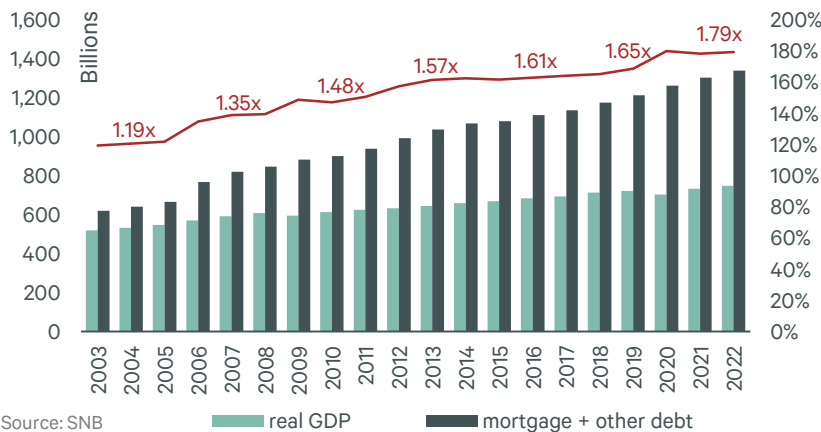


## Intro

The Swiss debt market has experienced significant and unprecedented changes since the financial crisis in 2008 until 2022. Starting with Basel III regulatory framework in response to the global financial crisis until the era of negative interest rates which ended abruptly in 2022 due to globally rising inflation rates. Since then, the Swiss National Bank (SNB) has been navigating a delicate balance in monetary policy to simultaneously control inflation and provide companies with enough liquidity. A significant component of the country's wealth is captured by a functioning debt market for mortgages, totaling over 1.2 trillion Swiss francs which is half of the French mortgage market. A substantial portion of this 1.2 trillion market will require refinancing in the coming years.

“ We observe a disparity between public sentiment and the lenders perspective regarding future development of the mortgage rates.

### MORTGAGE INCLUSIVE OTHER LOANS & GDP GROWTH



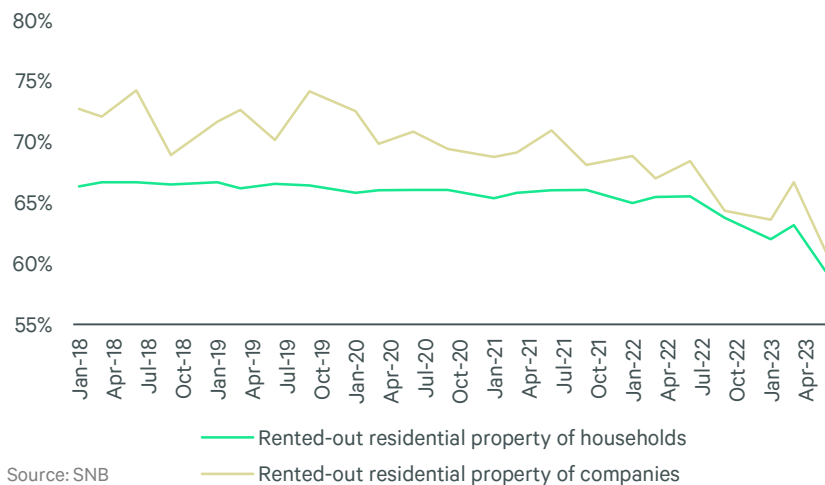
The financing costs comprise the SNB interest rate for the respective term, in addition to the bank margin. The focus of real estate investors has shifted strongly to financing costs and financial resilience since 2022. This article examines the present and future of the Swiss debt market, providing a concise understanding of underlying developments and potential alternatives to mitigate or even close the emerging funding gap due to various changes, which we will elaborate on in more detail below.

## Market impacts

Real estate investments have faced pressure due to higher SNB interest rates and the impact of the lower of cost or market principle for financing. The lower of cost or market principle dictates that banks can only finance the lower of the purchasing price or market value. This principle is not a hindrance in a growing market yet has become a limitation for investors seeking sufficient financing in a consolidating market. For mortgage borrowers, this translates into higher financing costs, lower asset valuations, and stricter lending terms.

This development can result in a funding gaps between what banks are willing or able to lend and what borrowers must finance to avoid large equity down payments. While some borrowers have sufficient reserves to cover the gap, those unable to fill the funding shortfall must find alternative approaches. Before exploring potential solutions, it is essential to address how the future situation may evolve.

### LOAN-TO-VALUE OF NEWLY ISSUED MORTGAGES



Source: SNB

Average LTV of rented-out residential property of companies (Jun-2023)

60%

Source: SNB

Average LTV of rented-out residential property of households (Jun-2023)

59%

Source: SNB

## Outlook

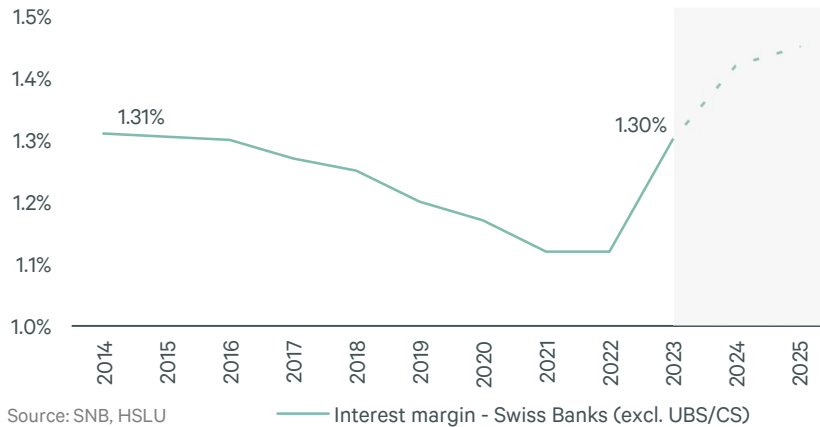
Several developments could impact the market in the near future. Firstly, new and stringent regulations coming from the Basel III framework are set to be implemented for Swiss bank lenders. Secondly, higher market concentration adversely affects market competition. Thirdly, regulations regarding sustainable financing are emerging in the Swiss market ultimately.

First major development are the new regulations pertain to the final phase of the Basel III regulation (known as Basel III Finalization). Basel III rules will be implemented in Switzerland over the course of 2024 and will affect the capital requirements of all Swiss banks, regardless of size and business model, across all risk profiles. For lenders, this means different risk weights for real estate exposures, impacting mortgage pricing. The principle of lower of cost or market value is being expanded and should now have a duration of five years instead of the previous two years after a change in ownership, affecting real estate developers' business models, and risk-adjusted sensitivity will impact LTV, rewarding lower and punishing higher LTV. Basel III entails various internal process changes for lenders, primarily banks, including IT infrastructure, governance, and reporting.

Expected change in net interest margin fo Swiss Banks (excl. big banks) between 2022 and 2025

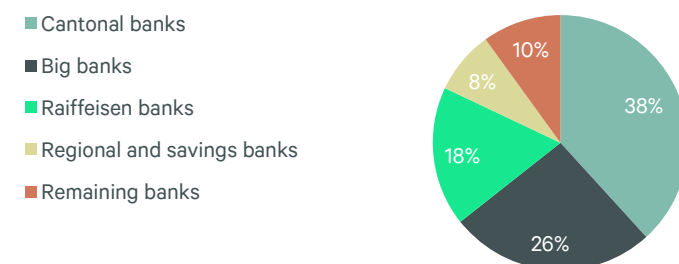
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**NET INTEREST MARGIN\* BY SWISS BANKS (EXCL. BIG BANKS)**



Regarding market concentration, it is particularly noteworthy that the Swiss market has lost a major competitive player with the dissolution of Credit Suisse into the UBS, which will become even more dominant in the Swiss debt market. CBRE estimates that UBS is planning to divest approximately CHF 4-6 billion from their IPRE credit book in 2024, which is expected to impact the overall financing costs of real estate investments in Switzerland, given UBS's dominant position.

**SHARES OF DOMESTIC BANK MORTGAGE MARKET IN 2022**



Source: Swissbanking, SNB

**\* NET INTEREST MARGIN:** The interest margin measures the relationship between the result from the interest differential business and a portion of the balance sheet total. Interest margins are calculated using the following formula: Net income from interest business divided by the sum of mortgage receivables, receivables from customers and financial investments.

Final major development is sustainable financing. The Swiss Supervisor FINMA has started regulating the management and disclosure of climate-related risks and will further increase supervisory scrutiny and therefore regulatory costs for lenders as well as borrowers going forward.

## Conclusion

Despite expected interest rate cuts in 2024/25, the total cost of debt for real estate investors is unlikely to decrease on the contrary. In contrary, lenders are likely to increase margins and update their risk-adjusted return, making it challenging for investors to obtain inexpensive debt for new acquisitions and developments. We observe already in the market a rise of bank margins across different banks of at least 15-20 basis points since September 2023. This development is not of short nature, it is expected to have lasting, long-term impact. We believe that currently, most borrowers are underestimating future financing costs and overestimating loan-to-values. In this context, refinancing existing loans becomes an issue as a debt funding gap emerges. Although Switzerland counts about 250 banks, only a handful are active in private debt financing, such as subordinated loans, bridging loans, mezzanine loans, or preferred equity. We foresee private debt solutions playing a pivotal role in bridging a substantial portion of the debt funding gap. However, it will be interesting to observe how the Swiss debt market adapts to the emerging challenges and opportunities, whether the Swiss regulatory authorities will encourage or hinder the entry of new market participants with innovative solutions.

## Contact

**Robin A. Müller**

Executive Director | Capital Advisors  
Bärengasse 29 | 8001 Zurich  
T +41 (0) 44 226 30 65  
Robin.mueller@cbre.com

**Marko Stjepandic**

Associate Director | Capital Advisors  
Bärengasse 29 | 8001 Zurich  
T +41 (0) 44 305 02 24  
Marko.stjepandic@cbre.com

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