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Swiss Federal Government introduces compulsory countercyclical capital buffer

Jurisdiction:	Switzerland
Date Issued:	18 March 2013
Date of Applicability:	30 September 2013
Asset Class:	None

Description

On February 13, 2013, the Swiss Federal Council, at the request of the Swiss National Bank (SNB), partially activated the so-called "countercyclical capital buffer" (CCB) with effect from September 30, 2013.

The purpose of the CCB is to strengthen the resistance capability of the Swiss banks and of the whole Swiss economy against risks arising as a result of imbalances in the mortgage and real estate market. The imbalances are as a consequence of a persistent increase in the amount of mortgage loans outstanding and, at the same time, in real estate prices for residential properties. These developments have been fostered by historically low interest rates, positive economic conditions in Switzerland and the continuous influx of high-income individuals: these factors have increased the demand for Swiss residential real estate over many years. This trend shows no signs of abating and there is a fear of a real estate bubble. The SNB has repeatedly issued warnings of such a bubble since 2010.

Function of the countercyclical capital buffer

The introduction of the CCB in Switzerland is a component of the Basel III framework. The SNB may request the Swiss Federal Council to require banks to hold, in the form of hard core capital, a capital buffer of up to 2.5 % of their Swiss risk-weighted assets. The rules governing the CCB provide for some discretion and flexibility, in particular with regard to the amount of the CCB and credit positions, so that the CCB can meet the actual needs of the market. The SNB monitors the market and may adapt or deactivate the CCB if it considers it appropriate to do so.

As the name suggests, the capital buffer is countercyclical, i.e. it is activated in times of excessive credit growth in order to create a safety cushion in the event of a potential market downturn.

For the time being, the Swiss Federal Council has required domestic banks to build up, by the end of September this year and then permanently to hold, an additional capital buffer amounting to 1 % of their directly or indirectly mortgage-backed risk-weighted assets where the mortgaged property is Swiss residential real estate. This applies to both owner-occupied and investment properties.

It is estimated that mortgage loans of between CHF 600 to 650 billion are involved and that additional equity capital of CHF 2 to 3 billion will be necessary to meet the new requirements. Therefore, it is mortgage banks that are mainly affected by the measure.

Mortgagors could also be affected, as the additional capital requirements of the banks could increase the price of mortgages. However, banks are confident that mortgage interest rates will increase by less than 20 basis points, i.e. less than 0.2 %, and that the effect of the new capital requirement on mortgagors will not be significant.

View of experts

Market participants do not expect the CCB to have a major influence on real estate prices or on the real estate market in general. The expected increase in the cost of mortgages is likely to be too small to have significant effects on the demand for residential properties or on their prices.

For this reason, some exponents consider that the CCB is not an adequate instrument in the fight against a real estate bubble. In their view, a general increase in interest rates would be preferable, but, given the risk of further

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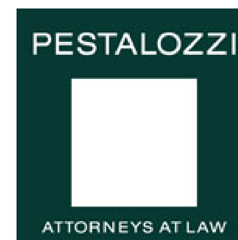

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appreciation of the Swiss Franc, rather impracticable. There is also the view that the CCB is more of a measure for financial stability.

Others, even more radically, see the CCB not as an instrument against the real estate bubble, but as a measure for the protection of private households and investors against over-indebtedness. In fact, they contend that the principal effect of the CCB is to increase the risk-sensibility of mortgagees to households that are not able to finance long term loans, and to investors that invest with high loan capital at low purchase returns.

Opinions also diverge on the timing of the activation of the CCB. Whereas some would have preferred to wait some time before activation, others see the measure as due. Likewise, opinions diverge on the need to activate the CCB for the entire country. Some market participants hold that limiting the CCB to hot spots such as the greater Geneva area, the Zurich region and certain tourist regions would be sufficient. Others agree with the SNB and the Swiss Federal Council that the CCB is required for the entire country.

Given the lack of experience of similar instruments applied under similar conditions, it will be interesting to monitor the effect of the measure on the real estate market over the next couple of months.

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