Eidgenössische Finanzmarktaufsicht FINMA
Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
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FINMA Guidance 02/2025

Risks in the real estate and mortgage markets

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Laupenstrasse 27
3003 Bern
Tel. +41 (0)31 327 91 00
www.finma.ch

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1 Introduction

The risks associated with real estate and mortgages remain important risks facing the Swiss financial centre, as detailed in the FINMA Risk Monitor. In particular, credit risk (credit default risk) and market risk of real estate (i.e. valuation risk) are a key focus of FINMA's supervisory activities.

FINMA performs various supervisory activities[1] and, where necessary, imposes institution-specific requirements such as capital add-ons. In 2024, for example, FINMA conducted a survey on mortgage underwriting criteria at 27 banks and 18 insurance companies as well as 6 on-site visits focusing on commercial mortgages.[2]

This guidance summarises the results of the supervisory activities performed and explains FINMA's expectations in connection with the regulatory requirements in the mortgage business. FINMA seeks to increase the transparency of its supervisory practice.

The guidance is aimed at banks, but it should be noted that other supervised institutions are in principle exposed to the same risks when granting mortgages and that FINMA takes the same principles into account when supervising them.

2 Legal framework

For banks, the obligation to record, limit and monitor their risks (including risks in the real estate and mortgage markets) arises primarily from the organisational requirements pursuant to Article 3 para. 2 let. a of the Banking Act of 8 November 1934 (BA; SR *952.0*) in conjunction with Article 12 para. 2 of the Banking Ordinance of 30 April 2014 (BO; SR *952.*02). The principles of risk management are set out in FINMA Circular 2017/1 "Corporate governance – banks". The capital adequacy of banks is governed by the Capital Adequacy Ordinance of 1 June 2012 (CAO; SR *952.03*).

For the mortgage sector, the national implementation of the final Basel III standards as of 1 January 2025 means, in addition to further qualitative requirements, in particular more risk-differentiated capital requirements in accordance with Article 72*c* CAO and the introduction of the principle of the original collateral value in accordance with Article 72*b* CAO (value at origination).

[1] These include mortgage stress tests, on-site visits, surveys and data collection/analyses.

[2] Financing of commercial real estate (CRE)

In addition, FINMA has recognised the guidelines on the minimum requirements for mortgage financing ("SBA minimum requirements") of 13 December 2023 and the guidelines for assessing, valuing and processing mortgage loans ("SBA mortgage guidelines") of 13 December 2023, both issued by the Swiss Bankers Association, as minimum standards in accordance with Article 7 para. 3 of the Financial Market Supervision Act of 22 June 2007 (SR 956.1). The SBA minimum requirements contain specifications for the capital to be contributed by borrowers and the amortisation obligations. The SBA mortgage guidelines contain principle-based qualitative requirements for creditworthiness, affordability, property valuations as well as monitoring and reporting (including provisions on exceptions to policy [ETP]).

3 Affordability

Findings from supervisory activities

According to Article 72*d* CAO, banks must ensure through internal directives that the affordability of the loans granted is guaranteed in a sustainable and systematic manner. However, as part of its ongoing supervisory activities, FINMA continues to find that banks tend to overestimate the creditworthiness of borrowers. Loose affordability criteria are often defined in the bank's internal guidelines, which vary greatly from institution to institution. In addition, a large number of banks grant a high proportion of financing outside their own affordability criteria (ETP).

Figures 1, 2 and 3 (see annex) show the distribution of the affordability criteria used.

Notes

The assessment of affordability should limit the credit risk and be based on sustainable criteria. FINMA considers the following criteria, for example, to be sustainable in the context of its supervisory activities:[3]

- For the owner-occupied residential property segment: an ETP affordability limit of 33% of sustainable <u>gross income</u> together with an imputed mortgage interest rate of 5% of the loan amount and imputed building-related maintenance costs of 0.8% of the collateral value (for new properties);
- For the owner-occupied residential property segment: an ETP affordability limit of 38% of sustainable <u>net income</u> together with an imputed

[3] This is based on the assumption of amortisation in accordance with SBA minimum requirements or more conservative amortisation according to the underlying risks.

mortgage interest rate of 5% of the loan amount and imputed building-related maintenance costs of 0.8% of the collateral value (for new properties);

- For the income-producing real estate segment: an ETP affordability limit of 100% of the sustainable net rental income together with an imputed mortgage interest rate of 5% of the loan amount and imputed building-related maintenance costs that reflect the age and condition of the property.

The criteria above do not represent a comprehensive assessment of sustainable lending. From a supervisory perspective, an overall evaluation of credit risk always considers the characteristics of a financial institution.

4 Collateral value

Findings from supervisory activities

A conservative property valuation and a cautious loan-to-value ratio are important factors in minimising the risk of loss in the event of loan defaults. According to Section 4.2 of the SBA mortgage guidelines, model-based valuation is permitted for properties. The method and statistical basis must be documented. Since 1 January 2025, the valuation models used must be validated annually and the results documented.[4] Validation can (but does not have to) be delegated. In any case, model valuations must be made plausible in a suitable and traceable way for third parties. If ranges exist within a model, these are part of the valuation model and are therefore covered by the aforementioned obligations.

As part of the survey in 2024, all 45 participating institutions stated that third-party hedonic models, among other things, are being used for property valuations.. The valuation models used may contain procyclical factors. FINMA has also observed the use of low capitalisation rates, which are sometimes fed into the valuation models and lead to a correspondingly high valuation of the property.

In connection with the hedonic valuation models, 21 out of 45 institutions (47%) reported that they do not regularly validate the valuation models used, including 8 banks. With regard to the capitalisation rate models, 14 out of 45 institutions (31%) do not regularly validate the valuation models used; this includes 9 banks.

[4] For banks, the version of the SBA mortgage guidelines valid until December 2024 explicitly required the use of validated valuation models only for owner-occupied residential property. The revised SBA mortgage guidelines, which came into force on 1 January 2025, require an annual validation or plausibility check that is comprehensible to third parties for all valuation models used.

In addition, more than 70% of the institutions reported the use of ranges[5] in the hedonic models. Of these, two thirds of the institutions use their own ranges and one third of the institutions use ranges provided by a third-party provider. Certain institutions reported the use of ranges without systematic controls and without documented justification of the deviation.

We have learned from feedback from an industry association regarding the principle of the original collateral value (value at origination) set out in Article 72*b* CAO that there is a need for clarification in this regard. It is apparently unclear for the industry whether the original collateral value must also be adhered to in the bank's internal credit risk management and in the definition of the lowest value principle, or whether it may deviate from the value relevant for determining capital requirements.

Notes

As part of its supervisory activities, FINMA attaches particular importance to the prudent valuation of mortgage collateral. This principle of prudence also applies to valuation assumptions and capitalisation rates.

An annual validation of the valuation models or a plausibility check of the internal or external valuation models used that is comprehensible to third parties must be carried out by an independent body.[6] Among other things, this validation or plausibility check can show whether model valuations are appropriate or whether adjustments are necessary to counteract a possible procyclical dynamic in the valuation.

If ranges are used, FINMA checks as part of its supervisory activities whether the calibration of these ranges and their use in credit processes is prudent. If the accuracy of the estimate provided by the hedonic valuation model is insufficient, another valuation method is preferable, for example in conjunction with an inspection of the property to be mortgaged. FINMA also expects deviations between the mean estimated value of the valuation model and the final collateral value to be justified in each case using objective criteria; this justification must be documented and must be comprehensible to third parties.

The lowest value principle defined by the banks and thus also the collateral values as part of credit risk management must be in line with the principle of the value at origination enshrined in the CAO.

[5] "Use of ranges" refers to allowing deviations between the mean estimated value of the valuation model and the final collateral value set by an institution.

[6] The validation of models falls within the scope of risk control, see also margin no. 72 of FINMA Circ. 17/1.

5 Loan-to-value ratio and amortisation

Findings from supervisory activities

As a result of the higher capital requirements for higher loan-to-value income-producing real estate introduced with the national implementation of the final Basel III standards, the stricter minimum capital and amortisation requirements for income-producing real estate introduced in 2019 were withdrawn.[7] FINMA has observed that the financing of income-producing real estate (including buy to let) involves higher risks than lending for owner-occupied housing and that such lending accounts for a significant proportion of the total mortgage portfolio at many institutions. For example, FINMA stress tests[8] show that the expected losses are particularly high in the income-producing real estate segment and especially in the sub-segment of income-producing commercial real estate. Figure 6 shows the cumulative expected loss rate for the various segments across the scenario horizon.

The self-regulation only sets a minimum standard when it comes to the specifications for the capital to be contributed by borrowers and the amortisation obligations. Banks thus set maximum loan-to-value limits amounting, for instance, to 80% in the owner-occupied residential property segment. In the income-producing real estate segment, and especially for commercial properties, banks set significantly lower loan-to-value limits for risk reasons.

FINMA also observed that additional collateral was not taken into account prudently when determining the loan-to-value ratio or in cases of indirect amortisation. For example, retirement assets with a significant portion invested in stocks were recognised at 100%, which meant that the market risks were not adequately taken into account.

In accordance with Article 72*a* para. 2 CAO, in the case of loans secured against several properties, the bank shall allocate the loan amount to the collateral values of the various properties using a suitable key to determine the loan-to-value ratio per mortgage. FINMA notes that some banks only perform this allocation in relation to the nominal value of mortgage notes. Such an allocation does not sufficiently take into account the risk perspective and therefore is not a systematically suitable key.

[7] These withdrawn, stricter minimum capital and amortisation requirements for income-producing real estate stipulated a minimum equity ratio of 25% of the collateral value and an obligation to reduce the mortgage debt to 2/3 of the collateral value of the property within a maximum of 10 years. Since 1 January 2025, only the cross-sectoral minimum requirements apply, which stipulate a minimum equity ratio of 10% of the collateral value that does not come from 2nd pillar assets (early withdrawal and pledge) and a reduction of the mortgage debt to 2/3 of the collateral value of the property within a maximum of 15 years.

[8] FINMA carries out stress tests for portfolios of existing mortgages at selected banks using its own methodology based on the assumption of a severe real estate crisis. FINMA examines what significant price falls or rate increases along with an economically unfavourable backdrop would mean for the banks concerned.

Notes

The SBA minimum requirements recognised by FINMA contain guidelines on lending and amortisation. Self-regulation represents a minimum standard, which is tightened up by the institutions in their risk policy to manage institution-specific risks where necessary. These minimum requirements should not be relaxed by the banks by means of ETP transactions. Lower loan-to-value ratios and higher amortisation rates going beyond the minimum requirements are to be determined by the banks depending on the risk of the financing. Overall, it is recommended to define loan-to-value limits in accordance with the risks and to reduce the building-up of risk. Due to the current risk situation, FINMA continues to recommend that for income-producing real estate (including buy-to-let financing) the loan-to-value limits should not be higher than 75% and that the amortisation requirements shouldbe kept on a higher level (see also FINMA press release of 27 March 2024 on mortgage loans).

Furthermore, the risks associated with additional collateral must be sufficiently taken into account in the context of the credit risk management. In the case of additional collateral provided by products without an assurance of capital preservation, appropriate collateral haircuts must be applied. Additional collateral must also be cautiously recognised as amortisation and, depending on the recognition, the development of any market risks must be monitored appropriately.

A suitable key (see Art. 72*a* para. 2 CAO) for the determination of the loan-to-value ratio for each property for financing secured by several real estate pledges must consider the risks (e.g. the loan-to-value limit). In addition, the amount of financing allocated to a pledge may not exceed the nominal value of the mortgage note for the same pledge.

6 Exceptions to policy

Findings from supervisory activities

In accordance with Section 7 of the SBA mortgage guidelines, lending outside of the bank’s own lending criteria is possible by way of exception (ETP transactions). However, these exceptions are only provided for in justified cases, and the decision must be comprehensible and verifiable and documented accordingly. ETPs in new business must be flagged at the start of the credit relationship and monitored according to their risk.

FINMA notes that a large number of banks grant a high proportion of loans outside their own lending criteria. The risks associated with high ETP ratios also depend on the ETP limits and affordability criteria set by the banks.

FINMA frequently identifies loose ETP limits and affordability criteria (see Section 3), while the ETP ratios for new mortgages (residential properties) have been at a high level since the start of the survey on new mortgages (HYPO_B). Figures 4 and 5 (see annex) show the development of ETP ratios (by volume) in new business since 2018.

In addition, FINMA found in the context of its on-site visits that ETP transactions performed by certain banks are not comprehensively flagged in existing business or when new transactions are concluded. For example, despite a lack of affordability, certain banks did not always classify the corresponding financing as ETP transactions

Notes

The Board of Directors approves the risk policy and the principles for institution-wide risk management as set out in FINMA Circ. 17/1. The risk policy lays down the rules for dealing with significant risks, the risk tolerance and the risk limits based on it. The risk tolerance is defined per risk category as well as at the level of the entire institution. Accordingly, the Board of Directors must also stipulate the risk tolerance in conjunction with mortgage lending activities.

As can also be seen from the SBA mortgage guidelines, FINMA considers ETP ratios to be one of the key risk indicators in the mortgage sector. The correct recording and classification of ETP transactions are essential in order to be able to monitor and manage the risks arising from them. The management of risks resulting from ETP transactions is based on these ETP ratios. Based on the defined risk tolerance as well as ETP limits and affordability criteria, ETP transactions in existing and new business are appropriately limited and ETP ratios are reduced if necessary.

In addition to other key risk indicators, FINMA welcomes the flagging and reporting of ETP transactions, particularly in the dimensions of affordability, loan-to-value ratio and amortisation. A separate as well as combined consideration of these dimensions makes it easier to form a comprehensible picture as part of the reporting in accordance with Section 8 of the SBA mortgage guidelines.

If sustainable affordability is not given, FINMA generally expects the mortgage transaction to be classified as an ETP so that such cases can be clearly identified, analysed and reported. Risk-mitigating measures, such as pledging additional collateral to secure interest and amortisation costs, are welcome, but do not directly cure an ETP transaction.

7 Commercial mortgages

Findings from supervisory activities

Certain institutions are heavily exposed to the commercial real estate segment and some have grown strongly in this segment in recent years. This area can be associated with greater risks than is the case, for example, with owner-occupied residential property. As mentioned (see Section 5), on the one hand, FINMA stress tests show that the expected loss rates in a severe property crisis would be highest in this segment. On the other hand, due to the continuing trends towards working from home and online shopping there are structural changes underway in the office and retail segment, which partially lead to high vacancy rates in some regions.

In 2024, FINMA conducted various on-site visits on the topic of commercial mortgages. Among other things, weaknesses were identified with regard to the definition of risk tolerance, the regular review of individual financing arrangements, and credit monitoring at the level of the entire mortgage portfolio.

Notes

Due to the specific risks associated with the financing of income-producing commercial real estate, FINMA expects the following when conducting its supervisory activities (particularly for institutions where this segment represents a material proportion of the overall mortgage portfolio or where there are growth ambitions):

- an appropriate frequency of reviews of such financing (including requesting tables of tenants) according to the risk, noting that in the past, for instance, a frequency of 15 years was deemed too low by FINMA for specific institutions;
- a detailed definition of risk tolerance with corresponding risk limits;
- systematic monitoring and reporting of credit risks at portfolio level, e.g. with regard to concentration risks by sector or region.

8 Reputational risks

Findings from supervisory activities

FINMA observes significant reputational risks in the lending business. This concerns, for example, counterparties with non-transparent structures within a group or companies involved in construction projects with a low risk capacity and/or a poor track record. FINMA has observed that some banks do not take sufficient account of reputational risks in the lending process, particularly when approving and monitoring loans.

Notes

Banks must systematically record, limit and monitor any reputational risks in connection with loans and counterparties (including the controller or the beneficial owner in the case of legal entities) in a way that is comprehensible to third parties, e.g. based on loan application forms during the lending process.

9 Annex

The following figures 1, 2 and 3 show the ETP limits applied by banks in practice with regard to affordability[9] depending on the projected costs[10] for self-occupied real estate (SORE) and for income-producing residential real estate (IPRRE). This demonstrates the distribution of the affordability criteria. Banks with high ETP limits and low projected costs (in the upper left area of the figures) have particularly extensive criteria. FINMA does not consider some of these constellations to be sustainable.

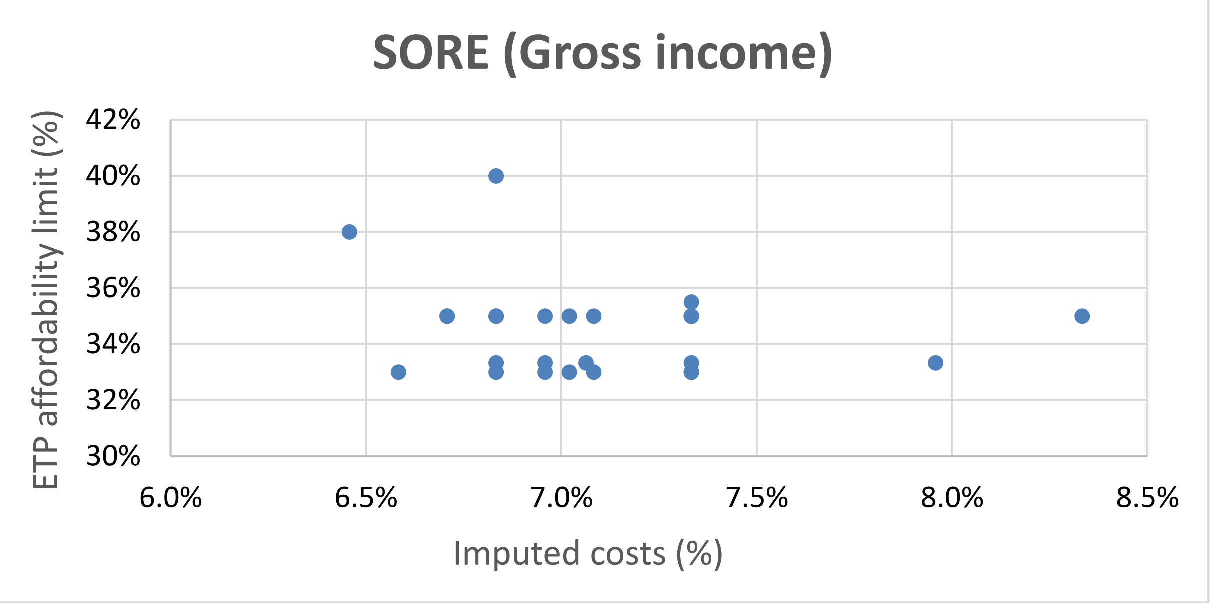

Figure 1 (source: FINMA surveys) – Distribution of affordability criteria for SORE for banks following an approach based on gross income

[9] For IPRRE, the ETP threshold is defined as a percentage of net rental income. For SORE, the ETP threshold is shown as a percentage of income (by gross income or by net income).

[10] Projected interest and ancillary costs. As the projected interest is calculated on the basis of the loan amount and the ancillary costs on the basis of the collateral value, a loan-to-value ratio of 80% for SORE and 75% for IPRRE was assumed in order to give a standardised representation of the projected ancillary costs. The projected costs are expressed as a percentage of the loan amount. It is assumed that amortisation will take place within 10 years for IPRRE and 15 years for SORE of 67% of the collateral value.

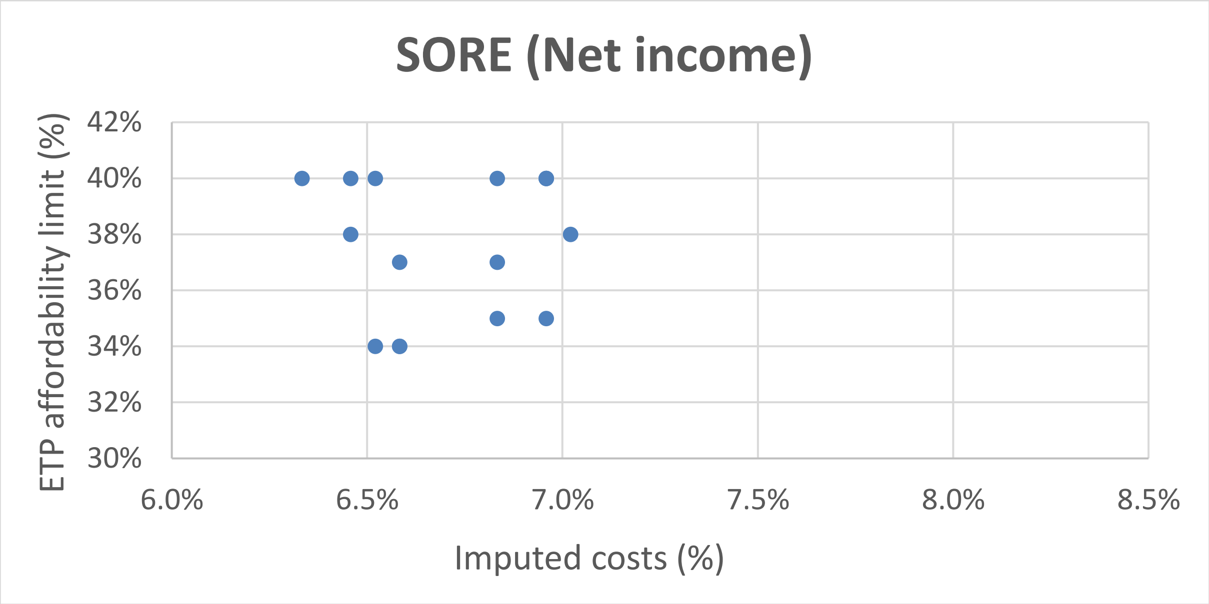

Figure 2 (source: FINMA surveys) – Distribution of affordability criteria for SORE for banks following an approach based on net income

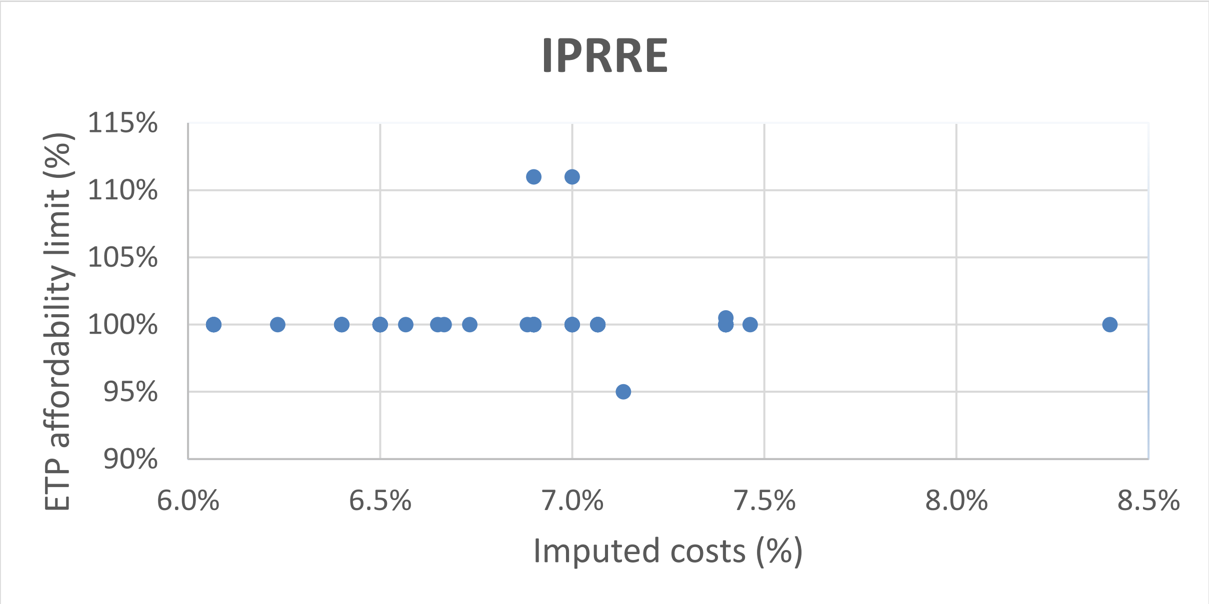

Figure 3 (source: FINMA surveys) – Distribution of affordability criteria for IPRRE

Figures 4 and 5 below show the aggregated ETP ratios (volume-weighted) in new business during the period 2018-2024 for 29 banks with a mortgage portfolio of over CHF 6 billion. The blue columns highlight the ETP ratios based on the ETP criteria defined by each bank. As each bank uses its own ETP criteria, the comparability is limited (see also figures 1, 2 and 3 for the affordability dimension). In order to ensure a certain degree of comparability, FINMA conducts further data analyses using standardised ETP criteria. If, for instance, the ETP criteria outlined in sections 3 and 5 are used on the data, the resulting ETP ratios are significantly higher than the ones represented based on the ETP criteria defined by the banks themselves.[11]

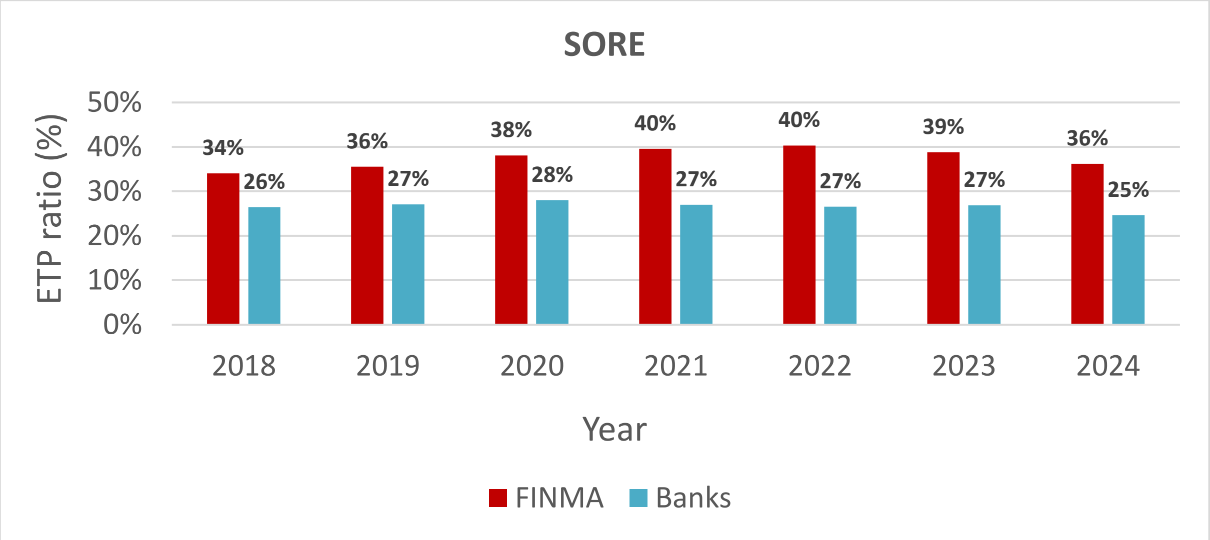

Figure 4 (source: Survey on new mortgages) – ETP ratios in new business according to bank's criteria as well as standardised criteria (SORE)

[11] For the red columns, the standardised criteria according to sections 3 and 5 for loan-to-value ratio, amortisation as well as for imputed interest rate, imputed ancillary costs and ETP affordability limit are applied. For the affordability calculation, the relevant income based on the bank's definition (Einkommen I) is considered.

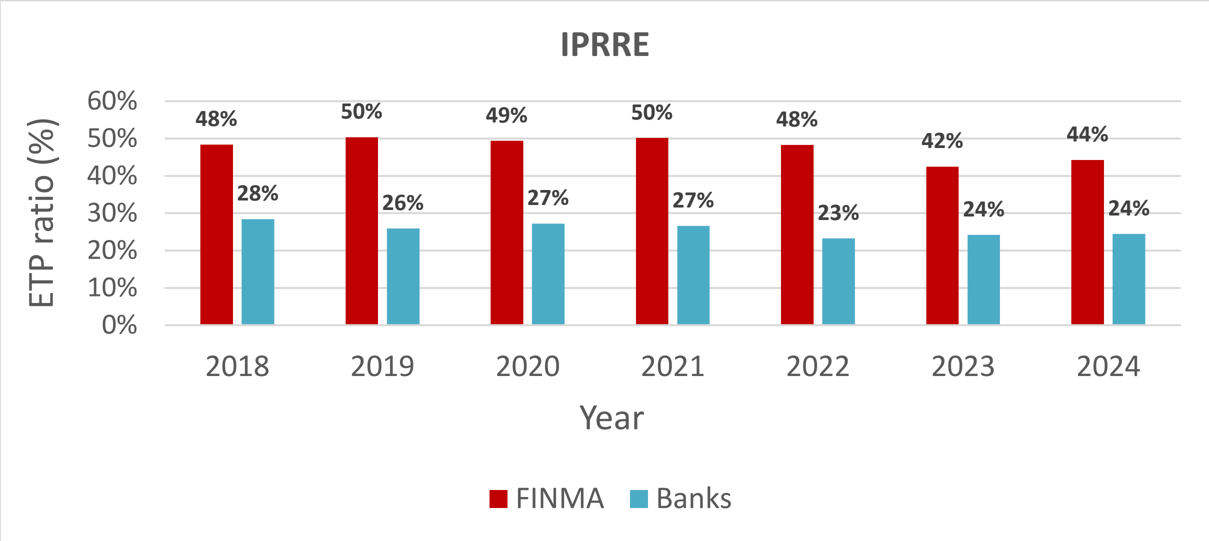

Figure 5 (source: Survey on new mortgages) – ETP ratios in new business according to bank's criteria as well as standardised criteria (IPRRE)

Figure 6 below shows the distribution of the cumulative expected loss rates over the scenario horizon for the various property segments SORE, IPRRE and IPCRE (commercial real estate) in the stress scenario of a severe property crisis. Properties in the IPRRE and IPCRE segments react more strongly to economic fluctuations than owner-occupied properties, which is why higher losses are to be expected for the corresponding portfolios in stress scenarios.

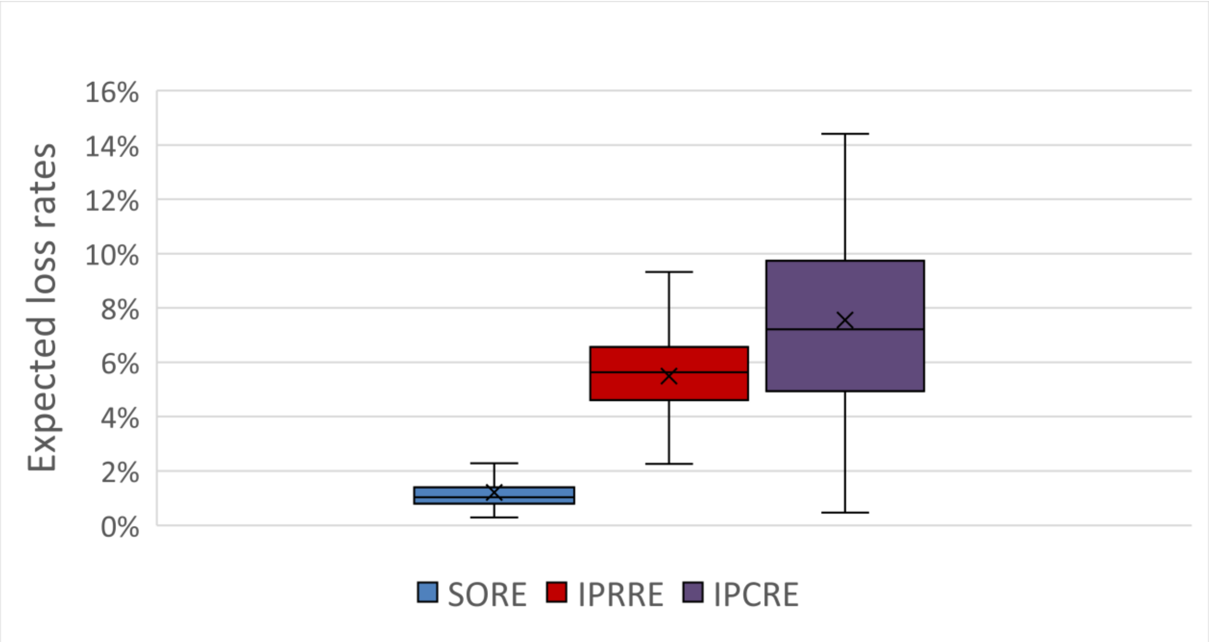

Figure 6 (source: FINMA mortgage stress test) – Distribution of the cumulative expected loss rates per property segment[12]

[12] The cross indicates the mean value per segment, the line indicates the median and the upper and lower limits of the rectangle correspond to the 75% and 25% quantiles respectively.