Illusion No. 15

GINESTA REAL ESTATE'S KNOW-HOW BRIEFING LETTER

Real estate brokers know nothing about financing!

... in order for us to set the record straight, read the important info in this bulletin on the topic of financing luxury and connoisseur properties.

Financing: An Overview
When reviewing home financing applications, Swiss lending institutions examine customer creditworthiness as well as the quality of the property. The financing structure and the affordability analysis play an important role here. Under normal circumstances, the lending ratio (loan-to-value ratio) on home ownership equals 80 % (risk) capital. Thus, the (potential) home owner normally has to put down 20 % of the purchase price in the form of equity or by pledging additional collateral. These assets can be made available to the homeowner in the form of savings capital, securities, entitlements or pension fund assets. If you earn an especially high income, then you can mortgage your equity instead of applying it to the purchase price. With financing structured this way, the mortgage could definitely reach 90-100 % of the purchase price.

But most of the time, a conventional financing structure is typical: the financing institution mortgages 80 % of the purchase price, most often divided into a first mortgage (65 %) and a second mortgage (15 %). The remaining 20 % of the purchase price is contributed by the homeowner from his/her own equity. Quite the contrary to other European countries, in Switzerland the mortgages do not have to be paid back in full. Normally, the 2nd mortgage is paid back by means of direct or indirect amortization until one reaches pension age, however no longer than within 20 to 25 years. On the other hand, the 1st mortgage often exists beyond retirement age.

In addition, affordability plays an important role, both at the beginning of financing as well as in retirement age. The affordability equation measures the level of housing costs (mortgage interest, amortization and incidental costs for maintenance) as a proportion of income. Depending on the financing entity, a maximum debt limit is set at roughly one-third of gross or net income. A few institutions set the limit at 28 % of net income, while others provide financing of the home ownership with housing costs of up to 33 % in relation to gross income. These different evaluations of affordability can amount to an income difference of approximately 10 %.

Luxury and connoisseur properties (CHF 2 Mio or more)
The financing of luxury properties differs substantially from conventional financing. It is worth taking a closer look at the special guidelines and mortgage policies of lending institutions (banks and insurance companies):

What are exclusive properties? The valuation criteria are many, and vary based on the lending institution. Generally speaking, the following property features apply to the valuation of luxury properties:

- Lavish amenities, such as swimming pools or swimming complexes
- Elaborate, above-average architecture
- Spacious, inviting floor plans (residential areas starting at 250 m^2 for apartments, 300 m^2 for houses)
- Special high-end materials (which may result in a high price per m^3 during construction)

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- Expansive grounds; highly elaborate gardens that are expensive to maintain
- First class panoramic views; preferred residential district
- Tax-efficient community of high social prestige
- Lakeshore or riverside abutment
- Market Value CHF 1.5 Mio ore more (apartments) und CHF 2.0 Mio (real properties)
- Amenities considered to be high-end customized features that a new owner might not automatically deem „intrinsically valuable“ (e.g., home theater; HiFi system wired throughout the house; large swimming complex with oversized pool; more than 4 garage spaces for a single-family home)

It is a matter of course that the property location is the most important criterion in the appraisal of an exclusive property. In locations with expensive land prices (e.g., Geneva-Coligny, Lausanne-Ouchy, Meggen, Zurichberg, Zurich‘s Gold Coast, the March Region in Schwyz Canton, Zug, Gstaad or St. Moritz), construction is typically more elaborate - and more expensive.

Of course, the total price (land costs and construction costs) is a defining factor; however, this varies sharply from region to region.

The connoisseur property

A few lending institutions have created an additional category - the „connoisseur property“ - which they will finance according to special guidelines. A connoisseur property is a special residential property that is considered unusual, and may have the following features:

- property with a different prior use (farmhouse converted into a residential home; industrial building redeveloped into residential lots)
- buildings of historic value or with historic landmark status
- properties that are difficult to sell (e.g., agricultural land)
- real estate with a conspicuously disproportionate relationship between land and improvements
- very costly, high-end home located among more affordable - and therefore less exclusive - housing structures (i.e., minimal market viability)

Often the market values of connoisseur properties are difficult to map in computational terms. For example, an extensive renovation of a farmhouse often costs much more than that of new construction. For the institution financing the loan, a „market value“ appraisal is often a discretionary matter, since conventional approaches to market value (such as comparable sales or the hedonic property value models) cannot precisely reflect the property‘s true circumstances.

Which factors are different in the financing of luxury and connoisseur properties in comparison to traditional financing? The following explanations reflect the differences:

Changes to the financing structure

Luxury and connoisseur properties are not mortgaged as high as ordinary properties. The owner must contribute at least 35 % to 40 % of the mortgage value in the form of equity capital for financing. The 1st mortgage only covers around 50 % of the property value; the 2nd mortgage often only a further 10-15 %. In most cases, the 2nd mortgage must be amortized through to retirement age; in many cases, even the 1st mortgage as well. Thus, the proportion of third party financing is reduced to 50 % of the property value - or even less.

Changes to affordability equation

Owners of exclusive real estate often possess high incomes and sufficient equity. In terms of value, the relatively high debt ratio often results from fiscal considerations. In addition, the unused cash funds cannot be invested in assets or be used in a business enterprise. For borrowers with a solid asset and income portfolio, the affordability calculation may also prove to be more than 33 % of gross salary. Depending on the income level, a 35-40 % share of living expenses to total income is not uncommon in the financing of luxury properties.

Changed bank relationships
Financing is often assessed by lending institutions by reviewing the overall customer relationship. Other business endeavors that the customer maintains with the lender (e.g., assets, insurance, business relationships) are also taken into account. When financing, the customer must assume that he/she will be evaluated by the lending institution as a whole, and „offsetting transactions" are required for good, favorable terms.

Unchanged interest conditions
Owners of luxury properties are most often rated AAA customers, and thanks to their creditworthiness and the often high level mortgage amount, often enjoy excellent loan terms. Depending on the situation (mortgage level, income conditions, other customer relationship aspects), a customer margin of 0.6 % through to 0.8 % may be charged on the respective refinancing rate (money or capital market rates). Normally, the customer margins range at around 1.0 % to 1.3 % for conventional financing – and thus substantially higher.

In sum, it can be stated that the financing of luxury real estate and connoisseur properties should be viewed very differently from conventional properties. Finally, a few tips to help you achieve successful financing of luxury and connoisseur properties:

- Inquire with your lending institution if your property is subject to normal financing, or is taxed as a luxury or connoisseur property. With a requiremen of at least 80% third party capital without additional collateral, you could quite easily find out how the bank evaluates your property.

- Compare the different terms and lending criteria. Some lending institutions are not interested in financing luxury or connoisseur properties, and therefore offer unfavorable terms.

- Consult with an independent advisor. There are professional mortgage and lending consultants who can elicit optimal financing with the best interest conditions for you, for a fee. This saves you time, and you will often get the fee repaid many times over in the form of favorable interest terms. When it comes to luxury properties, the potential savings may be quite considerable.

- It's good to focus on your entire relationship with the lending institution. However, avoid getting slammed with the „golden handcuffs" – and make sure you don't sell everything to the lender lock, stock and barrel!

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Claude A. Ginesta is a federally licensed real estate fiduciary (registered with the SVIT, the Swiss Federation of Real Estate Fiduciaries) and owner and CEO of Ginesta Real Estate AG. The company was founded in 1944 and specializes in the sale of properties in the Zurich and Grisons markets. With offices in Küsnacht, Horgen and Chur, the company operates as real estate broker throughout Switzerland for properties located across the country.

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