

## OVERVIEW OF MAJOR RECENT ACTIVITY IN SWITZERLAND'S REAL ESTATE MARKET

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Although the general economic outlook for the world economy in 2017 is seen as very positive by most economists, it is no secret that the Swiss real estate markets have peaked. Is this the beginning of the end of the real estate cycle, as UBS AG put it in its February 2017 House View report? The fact is that home prices are declining regionally; rental apartment vacancies are increasing; and commercial properties lack economic momentum. The strong Swiss franc makes the country's real estate even more expensive for non-Swiss investors. However, the national market remains very stable and is still a very attractive asset class.

The Swiss real estate market saw two particularly important developments in 2016.

First, although the US Federal Reserve decided in December 2015 to raise the Fed's key interest rate by a quarter point to a range of 0.25 to 0.5 (and, in December 2016, from 0.5 to

0.75), the still-low interest rates supported Swiss real estate prices in 2016. At the end of June 2016, following the Brexit referendum, even the 50-year treasuries of the Swiss Confederation showed a negative interest rate – thus intensifying the investment challenges and maintaining the attractiveness of real estate as an investment class.

Second, in 2016 immigration into Switzerland decreased by a two-digit figure for the first time. The resultant lower demand for apartments, together with heightened construction activity in this sector, led to increased vacancies – but created opportunities for lessees too.

The UBS Swiss Real Estate Bubble Index, relating to housing, stayed in the risk zone with 1.35 index points in Q4/2016, compared to 1.41 in Q4/2015.

The growth in the ratio of purchase prices to rents and income reflects increased interest rate risks. Of particular note is that the ratio of purchase prices to rent increased for the ninth quarter

in a row; it takes now 29.5 annual rent payments to purchase a comparable owner-occupied home.

Although office-space vacancies have decreased in bigger cities and in the portfolios of the listed real estate companies in 2016, the net return further decreased to about 2.5 per cent for A-class office space in bigger cities. Declining retail sales increased the pressure on rents and resulted in more retail space vacancies; at the same time, supply was increased by new space in shopping centres. According to UBS AG, 2017 rents are thus expected to drop by about 2 per cent for office space and about 3 per cent for retail space.

Despite these trends, construction activities remain at a high level. The construction index prepared by Credit Suisse together with the Swiss Contractors' Association (SCA) is set to remain at a high level of 144 points in the first quarter of 2017.

While building construction is expected to further increase in Q1/2017 by 4 per cent, civil engineering is expected to decrease by 3.4 per cent compared to last quarter. Building construction – in particular the production of rental apartments – is still fuelled by negative interest rates. However, in the long run, the building boom is likely to result in oversupply.

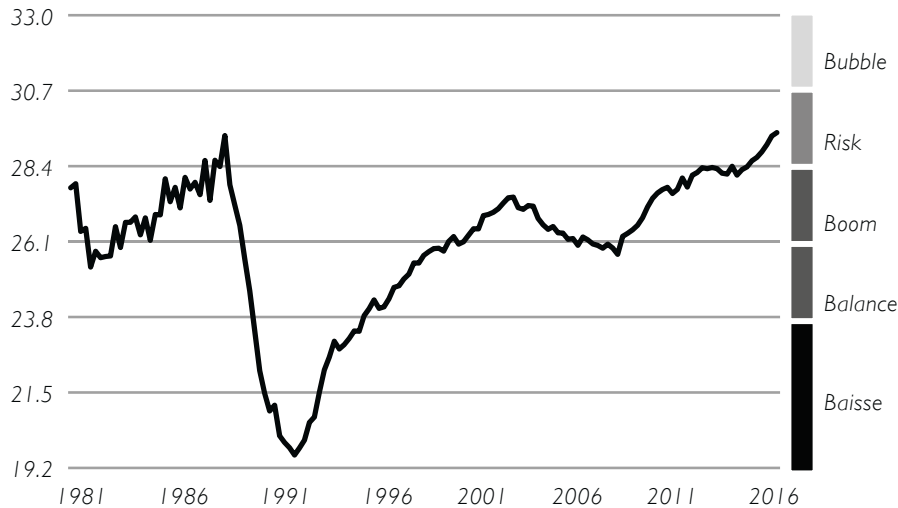
**THE SWISS REGULATORY FRAMEWORK**  
The Swiss real estate regulatory framework is based on transaction law, rental law, planning and zoning law, and construction law. As of 1 January 2017, no particularly important changes have been introduced to this regulatory framework; it is possible, however, that amendments may arise from current political debates. For example, the anticipated political decisions concerning the Energy Strategy 2050 will have a significant

UBS SWISS REAL ESTATE BUBBLE INDEX – 4Q/2016



Source: UBS Chief Investment Office Wealth Management

### OWNER-OCCUPIED HOUSING PRICES RELATIVE TO ANNUAL RENT PAYMENTS



Source: UBS Chief Investment Office Wealth Management

impact on the construction industry. In addition, the consultation period for the revision of the Swiss Federal Act on Acquisition of Real Estate by Persons Abroad (the so-called Lex Koller) has been postponed by the Swiss Federal Council several times since April 2015, when the Swiss Federal Council announced its intention to tighten the Lex Koller. The conciliation proceedings were finally opened on 10 March 2017.

The digitalisation of the economy, sometimes called industry 4.0, is heavily affecting the real estate sector too. Below is a brief summary regarding building information modelling (BIM) and its use in the building-permits system.

#### *Building Information Modelling (BIM) and the building-permit procedure*

Everybody is talking about BIM. This is an increasingly hot topic – not only for people directly involved in the building and management of real estate, but also for legal experts. An interesting issue here is the impact of BIM on the building-permit procedure.

Depending on its features, a BIM building model contains a great deal of the project information required by law for the building-permit application. In purely technical terms, many of the checks to which a building application is subject can be carried out using a

BIM model – either with the help of automated programmes or by way of manual analysis. If programmed correctly, BIM software is generally able to apply the building regulations under public law, which can be formulated as unique algorithms, and to automatically check that building models comply with these regulations. In this sense, BIM seems to have been created specifically for the purposes of the building-permit procedure.

Developers using BIM to plan and manage their projects can already, without much ado, programme their software to include specific regulations or rules of public construction law and relevant technical standards, and carry out automatic tests in order to improve the chances of success of their building application.

With the right software, the building permit authorities can carry out many of the tests for the building-permit procedure on the BIM model submitted with the building application. This will add depth, precision and efficiency to their tests. Unfortunately, these days very few government departments are likely to be technically equipped to work with and analyse BIM models; almost without exception, the provisions on the building-permit procedure that currently apply refer to building applications made on

paper. Here, BIM models can at most be used as part of a voluntary agreement between the applicant and the public authority, without any direct legal purpose and in addition to the prescribed and legally binding hard-copy documents. Under the current law, applicants do not have the right to use BIM models in the building-permit procedure, or to replace the traditional application documents by BIM models.

To date, there is no legal basis in any of the cantons that would allow the legally effective use of BIM models in the building permit procedure and the replacement of the traditional documents by BIM and similar models. As the current laws on building permits everywhere exclusively or also rely on paper documents and traditional building plans, BIM projects as such are

not yet viable and have to make use of traditional plans, lists, etc, derived from the BIM model.

Applicants for building permits thus do not yet have any right to replace their application documents with BIM models, and also have no chance to legally agree the submission of such models with the government authorities. This applies even if these models contain all the information required and could be used to generate the requested traditional documents, simply because the law does not make provision for the storage of information in this form. As far as can be seen, there is also no legal basis under which the public authority can force applicants to file BIM models against their will, even if such models should exist and the public authority should be technically equipped to handle such models. Another amendment to the law would be needed to change this, which is a good thing, at least in the sense that the use of BIM in the building permit procedure would give rise to many legal questions that can only be answered as part of the legislative process.

Where the relevant legislation is amended to allow the use of BIM models in the building-permit procedure (regardless of whether the use of such models is voluntary for both parties, at the option of the applicant or compulsory for

the applicant), rules must be formulated not only for the model, its contents, the quality of the information technology that is used and the format of the application documents referring to such models, but also for the ways and methods of transmitting these documents. It also needs to be determined which checks of which legal building requirements can be outsourced to suitable software by the authorities in what way and to what extent, and what standards have to be met by such software. Regulations on the public authority's internal policies and on the legal archiving, maintenance, updating and protection of BIM data must also be adopted (cf. *mutatis mutandis*

conditions and methods for passing these data on to other government departments and the purpose, subject matter and extent of the permitted use of the data by the authorities must also be determined.

If BIM tools should one day replace certain building application documents, we are then faced with the question of whether public disclosure of the building application as prescribed by law (ie, the application for planning approval) will apply only to the traditional documents generated from the model (plans, etc) or also to the BIM model itself, which is enclosed with the application (in read-only format or with the option of opening certain reports). The specific

permit procedure would also have to clarify which aspects of the submitted BIM model (and what level of detail) would be legally binding as regards the building permit, and which aspects can remain open with the capacity to change at a later date without violating the building permit. Not everything that is included in the BIM model when the building application is submitted will be needed for the building permit procedure.

In summary, it will likely take a while before BIM is fully accepted by the building-permit authorities.

#### *Energy Transition programme*

The Energy Transition programme is currently the subject of much discussion in Switzerland. After the parliamentary chambers adopted the first package of measures for the Energy Strategy 2050 in autumn 2016, the Swiss people rejected the initiative for withdrawing from the atomic energy programme in November 2016.

In summer 2016, the Federal Tribunal took a decision on the long-standing debate in the electricity sector on whether distribution system operators (DSOs) may pass on the costs of their own production and long-term procurement contracts in full to the customers dependent on them for their basic supply (end customers). The Federal Tribunal rejected the opinion of the DSOs and confirmed the legitimacy of what is known as the "average price method" applied by the Swiss Federal Electricity Commission (ElCom). According to this method, the full costs of own production may not be passed on the end customers in the basic supply chain if the DSO also has market customers.

Until now, many electricity companies applied the method by which electricity bought cheaply was sold to the large customers, while expensive electricity from their own production was sold to households and small companies – ie, customers who could not change their provider as they did not participate in the free market. This is likely to change in the wake of the Federal Tribunal's decision described above. It is difficult, however, to estimate the fall in prices for private customers. The earnings of the DSOs will drop, and they could even suffer a loss. If

### SWISS CONSTRUCTION INDEX: THE STATE OF THE CONSTRUCTION INDUSTRY AT A GLANCE

Q1 1996 = 100, seasonally adjusted, nominal, points = trend outlook



Source: Credit Suisse, Swiss Contractors' Association

article 33a para. 2, para. 4 and para. 5 of the Planning and Zoning Act of the Canton of Neuchâtel). With regard to updates, the primary concern here would be the adjustment of archived building applications to real-world changes; this also refers to the earlier question of whether the BIM model on which the building permit is based has to be updated when the building project has been finished in order to reflect the actual condition of the finished building (and possibly also including details that are not relevant to the building permit itself). The

procedure for the public disclosure of the model submitted for building approval would also need to be clarified, as the target audience will, at least for the time being, not have access to the necessary software or know-how. A general right to inspect the BIM model submitted with the building application could presumably best be granted via a suitable internet platform, but this approach would then give rise to specific issues related to data protection.

Legislation that makes provision for the use of BIM tools in the building-

the DSOs should abandon their business with market customers, basic service rates will go up again. Should their own production not be renewed, this would be in conflict – at least with regard to hydropower – with the objectives of the Energy Strategy 2050, which aims to strengthen the renewable energies. There is also the political question of whether Switzerland should protect its current level of energy supply.

In its judgment, the Federal Tribunal explicitly referred to the negative consequences for DSOs, highlighting that these were consciously accepted by the legislator at the time. It is thus the task of the (current) legislator to decide whether the negative consequences for DSOs are intentional. The political process of shaping the legislator's opinion has already started, and efforts are under way in political circles to set aside the basis for the "average price method" (ie, article 6 para. 5 of the Electricity Supply Act) retroactively to 1 December 2016. As part of the Strategy for Electricity Grids legislative project, the Swiss Council of States approved a related proposal by its Energy Commission on 8 December 2016. The matter will now go to the Swiss National Council. If it is also approved by the second chamber, the average price method will be cancelled with retroactive effect to 1 December 2016.

The Swiss People's Party has called for a referendum against the first package of measures for the Energy Strategy 2050. The referendum is expected to take place in May 2017. The Energy Transition programme, of central importance to the real estate industry, will continue to give rise to much discussion in the near future.

#### *Financing of real estate by non-Swiss investors*

On 4 November 2016, the Federal Tribunal decided on one aspect of the financing of real estate located in Switzerland by non-Swiss investors.

The case concerned a Swiss woman living in Dubai and married to a British citizen. The woman wanted to buy two properties for 1.6 million Swiss francs in the Canton of Fribourg, as sole owner. The Fribourg authorities told the woman that the purchase of the properties was not subject to the Lex Koller, and thus

did not have to be approved. The Federal Office of Justice appealed this decision, arguing that the great majority of the purchase price will be contributed by the foreign husband and will not be paid by the Swiss woman herself.

The Federal Tribunal shared the opinion of the Federal Office of Justice. It referred to article 5 of the Federal Act on the Acquisition of Real Estate by Persons Abroad and confirmed that Swiss citizens living abroad (like Swiss citizens living in Switzerland) do not need authorisation to buy a house or apartment in their native country. But the situation is different if the purchase price is mostly financed by a foreign creditor.

According to article 1 para. 2(b) of the Ordinance on the Acquisition of Real Estate by Persons Abroad, "the financing of the purchase or the construction of a building on the property" qualifies as "other rights that give the buyer a similar status as the owner of a property" if the "agreements, the amount of the loan or the asset relationships of the debtor create a special dependency between the debtor and the creditor."

If the non-Swiss mortgage does not exceed the usual limit of two-thirds of the value of the property, no authorisation is required as per the Federal Tribunal's practice. However, if 80 per cent or more of the purchase price is financed, the purchase of the property is subject to the Lex Koller. In this case, the creditor has a status similar to that of the owner. According to the Federal Tribunal, this is the case here: the British husband living in Dubai would contribute some 400,000 Swiss francs to the purchase price, and the couple would receive the agreed mortgage loan of around 1.1 million Swiss francs solely on the basis of the husband's income. In total then, the British husband would contribute more than 90 per cent of the purchase price to the financing of the real estate transaction, as calculated by the federal judges.

If non-Swiss persons or companies are involved in the financing of non-business properties (ie, real estate that is (mostly) used for residential purposes), a very close look should be taken at the transaction in view of the strict practices of the Federal Office of Justice and the Federal Tribunal respectively; if there is any doubt, prior

approval of the transaction should be obtained.

#### *Moratorium on the expansion of building zones*

The Federal Tribunal decided on a moratorium on the expansion of cantonal building zones for the first time on 26 May 2016. In answer to a complaint by the Federal Office for Spatial Development, the Federal Tribunal cancelled the rezoning of commercial land in the Orbe municipality in the Canton of Vaud at a public meeting. The re-zoning would have served the expansion of a company.

The revised Federal Spatial Planning Act (RPG) prescribes a transition period of five years from the entry into force of the amendment on 15 June 2012, during which the cantons have to adjust their structure plans to the new legislation. During this transition period, building zones in the cantons may not be enlarged. Re-zoning (ie, zoning an area) is only allowed if built-up land was previously or is simultaneously returned for environmental protection purposes. If cantonal land-use designation is important and urgently needed, the Ordinance on Spatial Planning (RPV) allows the canton to temporarily defer the related return of built-up land for environmental protection purposes.

In the case of Orbe, the Municipal Council approved an amendment to a land-use plan in 2013 and expanded the industrial and commercial zone by 42,000 square metres without removing the same area from the building zone elsewhere. Among other things, the re-zoning was meant to support the expansion of a local company and create jobs, and was therefore classified as urgent. The Federal Tribunal, however, cancelled this re-zoning, stating that exceptions from the obligation to compensate for re-zoned land have to be applied restrictively. Urgent reasons for re-zoning could include, for example, the building of a cantonal hospital or other public facilities. Although the desire to create jobs is legitimate, it is not such an urgent need in Orbe that the obligation to remove the same area from the building zone can be deferred. The re-zoning in Orbe can only be approved when other land areas in

Orbe or other municipalities in Vaud have been removed from the building zone.

*Permissibility of “ventilation window practice” in exceptional cases*

On 16 March 2016, the Federal Tribunal stated its opinion on the permissibility of the “ventilation window practice” at a public meeting. It considered whether, in areas plagued by noise, it is sufficient to measure the noise levels only at the least exposed ventilation windows of the rooms affected by noise.

In Niederlenz in Aargau, the Municipal Council approved the construction of three single-family dwellings in 2013. The intended residential zone borders on a work zone where an industrial enterprise causes considerable noise. As the noise emission levels were not met at all the windows of the rooms exposed to noise, the Administrative Court of the Canton of Aargau cancelled the building permits on 23 January 2015. The owners of the land intended for building the single-family dwellings appealed this decision of the Administrative Court to the Federal Tribunal, referring to the “ventilation window practice” applied in many cantons where noise emission levels only have to be met at one window per room affected by noise. The Federal Tribunal dismissed the appeal by judgment of 16 March 2016, explaining that the concept of protection underlying the Environmental Protection Act and the Noise Abatement Ordinance would require noise emission limits to be met at all the windows of the rooms exposed to noise. This condition is not fulfilled for any of the three houses. The “ventilation window practice” applied in some cantons undermines the philosophy of the protection of human health followed by the legislator, and reduces the pressure on the body politic to review and implement measures to avoid harmful or objectionable noise emissions at the source. It should be conceded, however, that there can be some conflict between noise abatement and the spatial planning interest in using the land available for household purposes and to increase residential density.

Exceptions may only be approved by the competent cantonal authorities if all reasonable noise abatement measures have been exhausted and the building project serves the purpose of quality urban development and densification. However, these conditions were not met in the case at hand.

*Landlord and tenant law*

In an interesting judgment, the Federal Tribunal discussed the consequences for the rental relationship of the reversion of a rented property under a building right.

If an independent and permanent building right expires and the structure built and rented under the building right reverts, the court held that this does not qualify as disposal (as defined in article 261 para. 1 Swiss Code of Obligations) if a priority notice regarding the rental contract had been entered in the land register (under article 261 para. 1 SCO, the rental contract will remain valid if the landlord sells the rented property after the rental contract was signed). The tenant was informed by the priority notice of the date on which the building constructed under the building right would revert; it is not decisive whether the tenant can still remember this at a later date. As the tenant could have started looking for alternative accommodation in good time before the reversion of the property, the tenant’s interest in the transfer of the rental relationship does not deserve protection. The Federal Tribunal did not answer the question of whether article 261 SCO can be applied (*mutatis mutandis*) if the tenant could not have known the date of reversion of the property.

**INDUSTRIES OR TYPES OF CLIENT THAT ARE PARTICULARLY ACTIVE IN THE REAL ESTATE SECTOR**

Our firm participated, as legal partner, in the set-up of the first Swiss digital real estate platform for institutional investors launched in June 2016 ([www.immovestore.ch](http://www.immovestore.ch)). According to market rumors, other real estate platforms will be launched in the near future.

Over the past year we have again been involved with various aspects of big real

estate area development projects with an investment volume of several hundred million each, particularly in the centre of Switzerland but also the country’s Western region. In the transactional market, for example, we represented an institutional client in the acquisition of an area near Zurich comprising two real properties, for which the client has developed a project with planned investments of around 300 million Swiss francs.

Finally, we were also involved in various real estate dispute resolution cases before courts in Switzerland, particularly in the areas of construction disputes and landlord-tenant conflicts.

**FORTHCOMING DEVELOPMENTS**

During the last decade, Swiss real estate has outperformed most other asset classes. Low interest rates, combined with the central banks’ extremely expansive monetary policy, have propelled the real estate market to an extent that would have been considered unthinkable before. However, conditions are getting more difficult. As shown at the beginning of this article there are signs that the peak has been reached in several areas of the real estate market. Interest rates are slowly increasing and inflation has returned. Consumption of area per capita, a longstanding growth factor, has reversed and will limit domestic demand. Competition in commercial and residential segments is rising due to oversupply. However, real estate remains a very stable asset class and the boom in the construction sector continues. Also, Raiffeisen and other banks have recently called for the Swiss National Bank to relax its very restrictive lending hurdles for mortgages, which would allow more individuals to purchase their own homes. It is quite possible that in the coming years, office-space owners will have to increasingly share some of the operative risks of the lessees in order to improve the attractiveness of the space – for example, in the form of partly turnover-based rents, already familiar in the retail market.

The Swiss real estate market still offers many opportunities, also due to developments in the field of digitalisation.