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International Views and Approaches

Valuation of Property for Lending Purposes

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We have asked Reiner Lux, the head of HypZert, which sets qualifications for valuers undertaking Mortgage Lending Valuations (MLV) in Germany, to write a short introductory piece on Long Term Value (LTV), of which German MLV is the best known example.

We are delighted at having received this paper by Reiner and his colleague Wolfgang Kälberer. LTV has been endorsed by Basel III and the European Union is meant to transpose it into European law. Consequently, LTV is subject to consultation on being added to the new five years' agenda of the IVSC. It appears pertinent for valuers worldwide to become acquainted with it, since global application in one form or another is surely imminent.

REINER LUX

Reiner Lux has been the Managing Director of HypZert GmbH since its formation in 1996. HypZert, located in Berlin, is the largest accredited certification body for real estate valuers in Germany with around 2,000 certified valuers in Germany and worldwide. HypZert is a member of the following committees and associations:

- IPC (International Personnel Certification Association)
- WAVO (World Association of Valuers Organisations)
- IVSC (The International Valuation Standards Council).

Reiner himself is also a member of the United Nations Economic Commission for Europe (UNECE) Real Estate Advisory Board.

Reiner is furthermore the Managing Director of vdpResearch GmbH, Berlin, Germany. vdpResearch was founded to meet the need for market information, especially regarding the development of property prices.

WOLFGANG KÄLBERER

Wolfgang Kälberer is a member of the Steering Committee of HypZert GmbH. He studied law in France and Germany. In 1988, he joined the mortgage banking department of Bayerische Vereinsbank AG in Munich.

In 1996, Wolfgang moved to the Association of German Pfandbriefbanks (vdp, formerly VDH) and headed its European Union division in Brussels. In this function, he was also a member of numerous working committees of the European Mortgage Federation and the European Covered Bond Council. In parallel, Wolfgang represented the VDH/vdp in the The European Association of Valuers' Associations (TEGoVA). He was a member of TEGoVA's European Valuation Standards Board. During this time (2013) he was awarded an Hon REV (Recognised European Valuer).

In October 2016, Wolfgang Kälberer was awarded the HypZert Certification & Valuation Award. Following his retirement from the vdp in 2019, he has been working for HypZert as a consultant on international valuation issues.

VALUATION OF PROPERTY FOR LENDING PURPOSES: THE LONG-TERM VALUE APPROACH

Long term or prudential value is a concept inspired by a value-at-risk approach which is intrinsic to any banking supervisory framework aiming at covering long term mortgage exposures of banks throughout their lifetime by stable collateral values. There is evidence that real estate markets are cyclical and correlated to economic cycles, sometimes triggering or reinforcing downtrend scenarios.

The L-TV differs from Market Value which is tied to a particular reference date and reflects the highest and best use of an asset (here: real estate). In times of market peaks/speculation, Market Values translate into maximized values on the top of the curve (as long as they are reasonably obtainable), i.e. follow the full range of market volatilities. In contrast, the L-TV approach is based on a more stable value ensuring that the banks' exposures are secured or covered with a reasonably high probability in all market circumstances, i.e. also during downturn scenarios with falling prices. The focus is on the correlation between real estate collateral values and financial market stability.

More recently, the long term value approach received global attention due to the new 'prudent value' concept of the Basel Committee on Banking Supervision (BCBS), commonly known as 'Basel III' and published end of 2017. The rationale of this concept is inspired from the principles governing the German Mortgage Lending Value approach.

THE ROOTS OF PRUDENT PROPERTY VALUATION: THE GERMAN MORTGAGE LENDING VALUE (MLV)

The concept of the Mortgage Lending Value dates back to 1900 and has been continuously enhanced since then. It is a prudent valuation approach focusing on the sustainable long-term characteristics of the mortgaged property, excluding speculative elements and cyclical fluctuations in value in order to enable the recoverability of the real estate collateral securing the exposure of the lender. The MLV serves two purposes: risk weightings of mortgages (lower capital allocation to collateralised loans) and valuation of cover assets for the funding of mortgages through Pfandbriefe/Covered Bonds (bonds secured by real estate).

The MLV was one of the drivers for Germany having been largely spared the worldwide turbulence seen on real estate markets in recent years. There are many reasons for this: as well as the differences in the structure and functioning of Germany's residential and commercial property market compared to other markets, its market is stabilised by the particular way in which property is financed. Fixed-rate lending, the widespread use of Pfandbriefe for the refinancing of mortgages and the associated use of the Mortgage Lending Value have made a substantial contribution to avoiding speculation and high levels of price volatility.

The MLV, as defined by the German Pfandbrief Act, represents the value which throughout the entire life of the loan can probably be achieved for a property that is sold on the free market - irrespective of temporary (e.g. economically induced) value fluctuations in the respective property market. This requirement serves to eliminate speculative influences. Only the long-term, sustainable features of the property are taken into account, as are present and potential third-party uses and users. This means that a MLV can only be determined if there is an alternative use/potential for use by third party uses and users. The property must be inspected, the analysis must be based on sound market data and based upon sustained property criteria. MLV must not exceed the Market Value under normal market conditions. The valuation report must be drafted by an independent and qualified valuer.

THE NEW BASEL III APPROACH

By publishing the new Accord of December 2017, the BCBS drew the conclusions from the global financial crisis where real estate markets were particularly impacted. Under the «Standardised Approach for Credit Risk - Real Estate Exposure Class», the BCBS implemented the principle of ‹prudent value› for real estate valuations, combined with a certain number of valuation requirements (see Basel III: Finalising post-crisis reforms, Standardised Approach for Credit Risk, Real Estate Exposure Class, par. 60 & 62). The new concept will be applicable as of 1 January 2023.

The prudent value principle requires that the valuation must be appraised independently using prudently conservative valuation criteria. To ensure that the value of the property is appraised in a prudently conservative manner, the valuation must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. National supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law. If a market value can be determined, the valuation should not be higher than the market value.

Although the Basel standards do not have the status of legal provisions, members (central banks and bank supervisors) from 28 jurisdictions are committed to implementing them in their jurisdictions. While the standards are designed to apply to large and internationally active banks, many jurisdictions have decided to enforce them on a wider set of banks. In many countries, banks with balance sheets of more than 20-30 bn Euro are generally subject to the full Basel rules.

The prudent value principle will be relevant for all banks across all capital allocation models:

- The prudent value principle is embedded in the Standardised Approach, i.e. applies to all banks using the Standardised Approach

- Through the output floor (OF) requirement of 72.5%, it also applies to banks using internal rating models (IRB banks). The OF requires that the capital requirements for IRB banks do not fall below 72.5% of the capital requirements calculated under the Standardised Approach

- As a consequence, all IRB banks must also apply the Standardised Approach and the prudent value definition as a reference ratio

As regards the European Union, the bloc is committed to transpose the Basel III Accord into European law, i.e. the prudent value approach is supposed to apply by law to all banks in the EU (Capital Requirements Regulation - CRR). The European Banking Authority (EBA) shares the view (see Policy Advice of 2 August 2019) that the Basel III requirements will no longer allow institutions to solely apply a Market Value concept as in any case they have to 'take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan'.

Additional specifications are required to clarify how a current use of either Market Value or Mortgage Lending Value could be included in the definition of property value. This would allow credit institutions currently using either the MV or MLV concept to continue to do so, provided that the values used as input parameters under these approaches exclude expectations of price increases and are adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan.

An expert group composed int. al. by IVSC/RICS/TEGoVA chaired by Prof. Crosby (Reading University, UK) and Prof. Hordijk (Tilburg University, NL) currently conduct a research project on the implementation of the new long-term value concept into valuation practice.

The underlying working assumptions are:

- The long-term or prudent value approach applies to each individual property (not at market or portfolio level)

- The new approach is not directed towards harmonisation of valuation methodologies

- Methodologies should remain principles based and flexible enough to be applied globally, respecting national specificities and complying with different national baselines, availability of data sources/series, quality standards, market structures etc.

RATIONALE AND UNDERLYING PRINCIPLES OF A LTV METHODOLOGY

It is assumed that the Long-Term Value approach shall be compatible with the major valuation models such as market value, investment value (through-the-cycle model) or mortgage lending value (under- the-cycle model). Similarly, all main valuation methods are supposed to remain applicable to the long term value concept (market comparison - income - cost). But inputs and indicators will need adaptation.

The underlying principles of the German MLV approach

The German MLV methodology is characterized by its prescriptive approach where most requirements (ratios, parameters, indicators etc.) are embedded in statutory provisions (Mortgage Lending Value Regulation "Beleihungswertermittlungsverordnung"). This translates into binding bands or ranges, specific safety margins, minimum and maximum thresholds, safety deductions and the requirement to include possible risks at certain points in the calculation. Land and buildings have to be valued separately.

There are minimum requirements for the qualification and independence of valuers. Valuers are required to prove specific professional skills, special knowledge and experience to carry out MLV valuations. Valuers who have been certified by a certification body such as HypZert according to EN ISO/IEC 17024 are assumed to possess such qualifications.

As regards the income method, the calculation basis is restricted to the net annual income produced by the property after deduction of the operating expenses. Only the income which the property is able to produce on a sustained basis shall be taken into account. The income must be obtainable by any owner of the property assuming proper management and permissible use during the remaining useful life of the building. Floored capitalization rates which proved to be sustainable throughout market cycles must be applied.

The operating expenses to be deducted cover management cost, maintenance cost, discounts for vacancy and modernization risks and other possible cost items specific to the property to be valued.

The same philosophy is valid for the cost and comparison methods. The value components of the cost approach must be reduced by a safety margin of at least 10%. Comparable values to be factored into the comparison method shall be assessed whether the underlying transacted price levels can be considered sustainable over the longer term. Again, values must be reduced by a safety margin of at least 10%.

Potential components of a Basel III Long-Term Value methodology

By contrast, a methodology for a L-TV that would work in practice and be globally applicable needs to be flexible enough to adapt to national specificities and market structures. The above referenced expert group recommends that inputs and indicators should ideally be derived from long-term data series and based on

- current indicators of rent, capitalisation rate and capital value
- vacancy and stock levels
- sustainable rental value and trends within sustainable rents
- indicators of where these values are within a long term trend
- indicators of depreciation in value of assets through time
- financial indicators based on long-run risk free rates and risk premia

- long-term indicators of residential capital values and their drivers.

The international implementation of a Long-Term Value concept will probably require major changes in valuation practice in most countries. Substantial challenges remain as regards

- market transparency and availability of property market information
- availability of long term and/or past trend data sets at individual property level (residential and commercial property)
- data quality
- procedure in case of opaque property markets, low market transparency and/or non-availability of longer run data sets
- alternative tools: could they be built on macro-economic data such as GDP, inflation rates, unemployment rates and their correlation with property price developments, long term rent levels, capitalization rates or property yields?
- short term solutions: would it be possible for the valuation profession and/or national authorities to determine an "adjusted market value" on the basis of certain prudential parameters?

There is strong evidence that additional guidance will be necessary at national level to address country specific issues (data issues, market structures etc.) and complementing a principles based L-TV methodological framework.

The IVS Forum is an informal association of senior property professionals and stakeholders in Israel. Our aims are to advance adoption of International Valuation Standards (IVS) in Israel and to disseminate international best practice within the Israeli profession. We hold regular webinars and publish international best practice papers in both English and Hebrew. You can find us on LinkedIn: https://www.linkedin.com/groups/9012136