Collateral valuation – a supervisory perspective

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Importance of robust & timely collateral valuation practices

• Findings of supervisory activities including the Comprehensive Assessment/AQR but also onsite inspections have highlighted deficiencies in the approaches employed by banks in relation to the completeness and accuracy of immovable property valuation.

• In the past, banks have often failed to obtain periodic financial information from borrowers or updated real estate valuations in order to assess the quality of loans on their balance sheets and the adequacy of collateral.

• Consequently, the banks failed to recognise early warning signs that asset quality was declining, which resulted in an understatement of balance sheet loan loss provisions.
ECB has clearly and transparently set supervisory expectations by publishing NPL main guidance on 20 March 2017

Overview of ECB guidance to banks on NPLs (final version published in March 2017)

- The Guidance to banks on NPL’s contains chapters on all relevant aspects relating to NPL’s.
- The Guidance contains a dedicated section on collateral valuation as collateral valuations serve as a significant input into loan loss provisioning estimations.
- The chapter outlines supervisory expectations in terms of collateral valuation governance, monitoring and methodology.
Key findings from 2017 on-site inspections in NPL data integrity:

Many findings in this area including:
- a lack of risk data aggregation processes, for data relevant to the detection of financial difficulties (e.g. data from income statements, EBITDA, DSCR).
- Key parameters (e.g. collateral haircuts, discount times, cure rates) are often significantly misestimated and the criteria for write-offs (e.g. expressed as time in default) are in many cases not clearly defined.

Source: SSM Annual supervisory priorities report 2017
Supervisory expectation is that Banks (SI’s) will have ….

**Policies & procedures:**
- Written documents
- Board approved
- Asset type specific
- Annual review
- Aligned to risk appetite

**Monitoring & quality control:**
- Robust process
- Monitor valuations outcomes & quality
- Challenge valuations
- Back test
- Test independence of valuer’s

**IT capabilities**
- Database of collateral
- Database of transactions
- Enable data quality & integrity
- Consistent application – common sources & definitions

**Strong Governance will enhance banks ability to implement robust collateral valuation framework**
Collateral Valuations – Supervisory expectations.

Individual Vs Indexed valuation: Supervisory expectations

- **What is an individual valuation?**
  - Property-specific appraisals, which are performed by an appraiser on a specific property basis and are not based on indexation or any other automated process. Individual property valuations should be performed in line with supervisory expectations.

- **Focus on individual valuations above 300k**
  - An *individual valuation* for all immoveable property securing NPL loan > **300k** (CRR requirements also apply) i.e. indexation is only allowed for those under 300k.

- **Use of indexed valuations?**
  - Yes but for those properties securing NPL’s under 300k
  - Can be internal/external but needs to be: reviewed regularly, sufficiently granular, based on sufficient time series of empirical evidence
Collateral Valuations – Supervisory expectations.

✔ **New** individual independent valuation once classified as NPL for all those > 300k and **minimum every 12 months** after that!

✔ For updated valuations which have taken place in past 12 months, property value can be indexed to the date of impairment.

✔ Banks are to carry out more **frequent valuations** where market is subject to significant change and/or changes occur which would trigger lower value in property.

✔ Banks should define criteria in their collateral valuation policies and procedures for determining that **a significant decline in collateral value** has taken place.

✔ These will include **quantitative thresholds** for each type of collateral established, based on the observed empirical data etc.
Appraisers should be (not exhaustive list)

• Independent - Not involved in the loan processing, loan decision and credit underwriting process;
• Not guided or influenced by the debtor’s creditworthiness;
• Does not have an actual or potential, current or prospective conflict of interest regarding the result of the valuation;
• Does not have an interest in the property & Is not a connected person to either the buyer or the seller of the property;
• Provides an impartial, clear, transparent and objective valuation report;
• Should not receive a fee linked to the result of the valuation
• be professionally competent and have at least the minimum educational level that meets any national requirements to carry out such valuations;
• Have the necessary knowledge of the subject of the valuation, the real estate market in which it would trade and the purpose of the valuation.
Collateral Valuations – Supervisory expectations.

Valuation methodology as an input to provisioning:

✓ Banks should have defined collateral valuation approaches per collateral product type which are adequate and appropriate for the asset class in question.

✓ Supervisory expectation is that the present value of a collateral (using the valuation as a basis), as determined by the bank, has to consider:
  ✓ an adequate time to sale (i.e. the sale has to be placed at a realistic point in time in the provision calculation) – macro conditions
  ✓ an adequate haircut including relevant legal, sale costs.

  ▪ Haircuts should always consider the characteristics of the relevant jurisdiction, especially specific valuation regulations as well as the efficiency and effectiveness of local foreclosure proceedings.

✓ Both have to be derived using reliable and representative internal data.

✓ In the absence of such data supporting the bank’s assumptions, the present value is expected to be prudentially adjusted downward by the bank (e.g. by applying higher haircuts).
What do we mean by foreclosed assets?

- The asset is **taken onto the balance sheet** of the bank – title/ownership transfers to the bank.

Valuation of Foreclosed Assets:

- Banks are **strongly encouraged** to classify foreclosed real estate assets as non-current assets held for sale under IFRS 5.

- This accounting treatment implies that the management should approve an individual plan to sell the asset within a short timeframe (normally one year) and that an active sales policy should be pursued (FRS 5.8); thus, it favors recoveries.

- Given this premise, foreclosed assets received should be valued at the lower of:
  1. the amount of the financial assets applied, treating the asset foreclosed or received in payment of debt as collateral;
  2. the fair value of the repossessed asset, less selling costs.
Q&A

Thank you!!
Figure 21 Decision tree for valuation purposes

1. Is there sufficient information to produce a valuation?
   - No
     - Is there hope value associated with the property?
       - No
         - Are there comparable transactions in the market?
           - No
             - Land without planning or change of use
               - No
                 - Valuation = 0
               - Yes
                 - Value on the basis of comparable recent market transactions on arm’s length terms
                   - Type of property
                     - Vacant property or land
                       - Comparison method based on valuation per square unit of area
                     - Tenanted property
                       - Comparison method based on net effective rent
           - Yes
             - Value based on land value/-existing building use.
   - Yes
     - Ascribe hope value based on DCF analysis of future cash-flows

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