



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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**Sharon Finn**  
**Advisor**  
**DGMS2**  
**ECB**

# **Collateral valuation – a supervisory perspective**

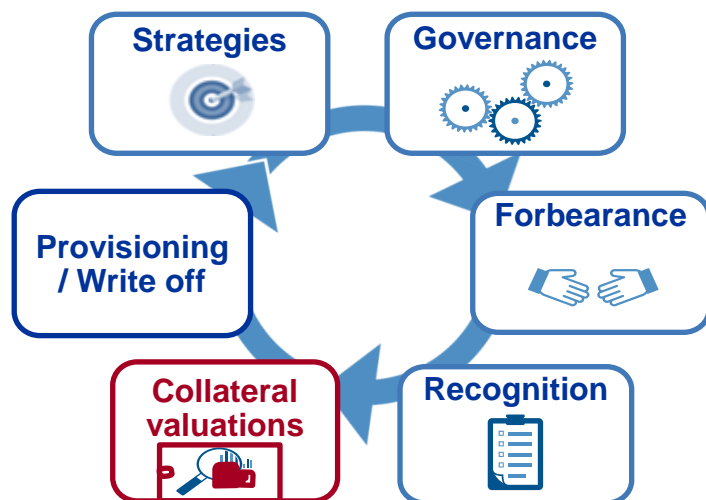
**World bank conference**  
**15/16 May 2018, Vienna**

## 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.

# Collateral Valuation – one of the key supervisory priorities for the SSM

























## 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 priorities for 2018 and beyond

Priorities 2018	Supervisory activities for 2018 & beyond	Continued from 2017	Likely to be continued in 2019 <sup>5</sup>
Business models	 Interest rate risk implications for banks' business models/profitability		
Credit risk	 Consistent approach to NPLs <sup>1</sup> /forborne exposures (e.g. deep dives/OSIs)		
	 Exposure concentrations & collateral management and valuation (e.g. real estate, Level 3 assets)		
Risk management	 TRIM <sup>2</sup> : Credit risk, market risk and counterparty credit risk models		
	 Improvement of banks' ICAAP <sup>3</sup> and ILAAP <sup>4</sup> approaches		
	 Evaluate banks' preparedness for IFRS 9 and other regulatory changes		
Multiple risk dimensions	 Brexit preparations		
	 EU-wide (biennial) and SSM-wide stress test exercise		

1) Non-performing loans.

2) Targeted review of internal models.

3) Internal capital adequacy assessment process.

4) Internal liquidity adequacy assessment process.

5) Light blue ticks indicate follow-up activities.



# Collateral Valuations – Supervisory expectations.

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**

## 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 immovable 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

- ✓ **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.



## 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

