International Conference

A comprehensive approach to NPL resolution –international experiences

Collateral valuation – an appraisers' perspective

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The European Group of Valuers' Associations (TEGoVA)

- Europe's property valuation standards setter since 1977
- 70 member associations
- 36 countries (including Canada, USA, UAE)
- 70 000 qualified valuers

Outputs

- European Valuation Standards
- Minimum Educational Requirements
- Code of Ethics
- Pan European REV Designation
- TEGoVA Residential Valuer (TRV)
- Methodology (European Practice & Methodology Board)

Key EU Law Impacting Valuation of Real Estate for Loan Collateral Purposes

1) Mortgage Credit Directive

2) Capital Requirements Regulation

Mortgage Credit Directive – Valuation Provisions

Article 19: Property Valuation

1. Member states shall ensure that reliable standards for the valuation of residential immovable property for mortgage lending purposes are developed within their territory…..
2. Member states shall ensure that internal and external appraisers conducting property valuations are professionally competent and sufficiently independent from the credit underwriting process so that they can provide an impartial and objective valuation, which shall be documented in a durable medium of which a record of it kept by the creditor.

Recital 26.

…In order to be considered reliable, valuation standards should take into account internationally recognised valuation standards, in particular those developed by the International Valuation Standards Committee, the European Group of Valuers' Associations or the Royal Institution of Chartered Surveyors….”

Capital Requirements Regulation
Capital Requirements Directive (CRR/CRD IV)

The ‘CRR/CRD IV’ package transposes new standards on bank capital (Basel III agreement) into the EU law from 1 January 2014

- The CRR/CRD IV package **is not only of significance to the world of banking but also impinges on real estate valuation:**

  - Definition of values
  - General valuation principles

Capital Requirements Regulation Definition of Market Value

Article 4 *(76)*

'market value'
means, for the purposes of immovable property, the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion;

Capital Requirements Regulation cont'd

Article 229(1)

"For immovable property collateral, the collateral shall be valued by an independent valuer at or at less than the **market value**…

In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or at less than the **mortgage lending value…** "

Capital Requirements Regulation cont'd

Article 208 provides the following requirements on **"monitoring of property values**" and on "**property valuation":**

a) institutions monitor the value of the property on a frequent basis and at a minimum once every year for commercial immovable property and once every three years for residential real estate. Institutions carry out more frequent monitoring where the market is subject to significant changes in conditions;

b) the property valuation is reviewed when information available to institutions indicates that the value of the property may have declined materially relative to general market prices and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. For loans exceeding EUR 3 million or 5 % of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years.

Institutions may use statistical methods to monitor the value of the property and to identify property that needs revaluation."

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European Valuation Standards 2016

- Based on EU law wherever relevant and contain applications of particular EU importance
- Pan-European valuation tools including a European Code of Measurement, a risk analysis tool (Property and Market Rating) and a European Code of Ethics

- **Information Paper on Valuation Methodology**

- **Section on Valuation for Secured Lending**

- **Section on Valuation for Financial Reporting**

European Central Bank Guidance to Banks on Non-performing Loans March 2017

Chapter 7 - Collateral valuation for immovable property

Findings of supervisory activities and onsite inspections have highlighted deficiencies in the approaches employed by banks in relation to the completeness and accuracy of immovable property valuation.

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.

Scope of Chapter 7

- Sets out supervisory expectations and best guidance regarding policies, procedures and disclosures which banks should adopt when valuing immovable property held as collateral for NPLs.
- Banks to monitor and review the valuations performed by appraisers on a regular basis.
- Banks should develop a robust internal quality assurance policy and procedures for challenging valuations completed internally and externally.
- Quality assurance process should be carried out by an independent risk control unit.
- Independence of the external appraiser selection process should be tested on a regular basis.
- An appropriate similar sample of internal and external valuations should be compared against market observations on a regular basis;

Valuation Methodology

- Banks should have defined valuation approaches per collateral product type
- All immovable property collateral should be valued on the basis of market value or mortgage lending value as allowable under Article 229 of the CRR.
- Overall valuations based only on the discounted replacement cost should not be used.
- For income-generating properties a market comparable or discounted cash-flow approach can be used.
- Property should be valued, per European and international standards incl European Valuation Standards EVS-2016 (Blue Book) and RICS. National standards can also be accepted if they follow similar principles.

Methodology - The Valuation Profession's Final Frontier

A Diversity of Valuations Approaches across Europe, in particular concerning

- Income Approach
- Discounted Cash Flow (Implicit/Explicit)
- Yields / Discount Rates

TEGoVA has established a European Practice and Methodology Board (EPMB) to seek harmonisation of valuation methodology

European Valuation Standards 2016 include Information Paper EVIP 5 on Valuation Methodology

EVIP 5 Valuation Methodology

European Valuation Standards recognise 3 valuation approaches:

- Market (comparative) approach
- Income Approach (including Simple Capitalisation and Discounted Cash Flow)
- Cost Approach (as a last resort and not allowed under ECB Guidance)

Confusion Surrounding "Yields" in Valuation of Commercial Properties

Illusory Consistency, Confusion and Lack of Transparency

- Initial Yield
- Gross Yield
- Net Yield
- All Risks Yield
- Equivalent Yield
- Equated Yield

Definitions

- **Initial yield** is also known as the straight yield, the flat yield or the running yield. It is the current annual rental income divided by the capital value and multiplied by 100 to get a %
- If the property has been let recently at a Market Rent, the initial yield is the same as the all risks yield. Some valuers use **initial yield** to mean **all risks yield**
- The **all risks yield (ARY)** is calculated by dividing the net rent by the capital value of a recently let property
- The **all risks yield** reflects the markets perception at a point in time of the future effect of all the risks associated with the property including increasing or decreasing rental income

Net Yield

- Some valuers, particularly in UK, adopt **Net Yields**
- A net yield is calculated after first adding purchase costs (agents' fees and legal costs) to the agreed sale price

Thus using the example of a property sold at a contract price of €1 785 000 and let at €125 000 per annum and assuming purchase costs of 6%, the Net Yield becomes:

€1 785 000 and let at 125 000 / (1 785 000 + 107 100) X100 = 6.6% (compare with gross yield of 7%)

Net and Gross Values

Important to note!

- The adoption of a Gross Yield results in a Net Value (this is Market Value as defined, i.e. excluding purchase or sale costs)
- The adoption of a Net Yield results in a Gross Value (incorporating purchase costs)

NB. Some banks particularly German often ask for a Gross Value

Implicit Cash Flow / Equivalent Yield

- The **Equivalent Yield** in valuing investment property this is the one rate of discount which, when applied to all income flows being discounted, produces a present value equal to the capital value of the investment. The income reflects current actual rents and costs and current levels of rental values, It is the internal rate of return where the cash flow changes are allowed for implicitly.
- In equivalent yield valuations the valuer makes intuitive adjustments to equivalent yields and all risks yields from sales analysis to reflect different levels of risk between the comparables and subject property.

Explicit Cash Flow /Equated (Target)Yield

- In valuing investment property, the **Equated Yield** is the internal rate of return, being the discount rate which needs to be applied to the flow of income expected during the life of the investment so that the total amount of income so discounted at this rate equals the capital outlay.
- Rents at review, lease renewal, or re-letting take account of expected future rental changes due to variations in the value of money, i.e. the calculation reflects the valuer’s views of inflation as well as his views on rental changes due to other factors. It is the IRR where cash flows are allowed for explicitly.
- Equated yields are used in growth explicit valuations. Investors may use the terms Discount Rate or Target Rate.

Discount Rate/ Equated Yield Simplified

- The Equated Yield – Discount Rate is simplified by most valuers and is derived from premium - The risk free rate plus
  - The property risk premium
    - The sector
    - The town premium
    - The property premium
      - -The tenant risk
      - -The lease risk
      - - The building risk
      - - The location risk

A Warning

- DCF valuations can be dangerous if equivalent or initial yields are confused with equated or target yields
- Initial or equivalent yields are market based and may provide the safest tool for market valuations
- Valuers should always give a definition of the yield that has been used

The Danger of Predictions

25 years ago :

- Prime office rents in Warsaw exceeded USD 50 per sq m per month
- Prime office yields were perceived to be at around 15%
- The first major Warsaw office investment transaction in 1997 reflected a yield13%

Who could have predicted at that time that in over 10 years rents would have dropped to below USD 30 per sq m and prime yields would have been fast approaching 5.5%

What assumptions to be made in a 10 year cash flow today?

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Thank You!

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