WAVO Webinar

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Understanding the new Prudent Value approach for Real Estate Valuation of the International Basel III Framework

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- The new Prudent Value principle
- The transposition of the Basel III Prudent Value approach in the European Union
- Possible components for a Prudent Value methodology

The BCBS Standard Setting

- The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks composed by central banks and bank supervisors from 28 jurisdictions
- By publishing the new Accord of December 2017, the Committee drew the conclusions from the global financial crisis where real estate markets were particularly impacted
- Although the Basel standards don’t have the status of legal provisions, members are committed to implementing them in their respective 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

Relevance of the Basel Framework for Credit Institutions

» Banks are required to hold enough capital in order to address credit risk, market risk and operational risk

» As regards credit risk in the context of real estate lending, the framework offers substantial equity savings under certain conditions

- ➢ Possible regulatory capital relief of 25% up to 70% for each mortgage loan depending on the loan-to-value ratios
- ➢ Compliance with certain conservative loan-to-value ratios (LTV limits)
- ➢ Availability of the property as a security (risk mitigation through mortgage collateral)
- ➢ Thorough and prudent valuation of the property (prudent value principle)

The Prudent Valuation Principle of the Basel Framework

» Under the "Standardised Approach for Credit Risk – Real Estate Exposure Class", the BCBS implemented the principle of **'prudent value'** for real estate valuation, combined with other valuation requirements (see Basel III: Finalising post-crisis reforms, Standardised Approach for Credit Risk, Real Estate Exposure Class, par. 60 & 62)

» **The value-at-risk principle**: the BCBS prudential approach is based on the requirement that real estate collateral shall be covering the banks' long term mortgage exposures throughout the lifetime of the loan, including volatile market conditions and/or crisis scenarios

Application of the Prudent Value Principle

- Relevance of the ‘prudent value’ principle for all banks irrespective of the risk weighting model used (Standardised vs. Internal Ratings based approach):
  - 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 applying 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
  - All IRB banks must also apply the Standardised Approach and the prudent value definition as a reference ratio
- The prudent value principle will be applicable as of 1 January 2023 (see Basel CRE Standard 20.71)

The Prudent Valuation Principle of the Basel Framework

(Basel CRE Standard 20.75 of December 2017)

The valuation of the property 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.

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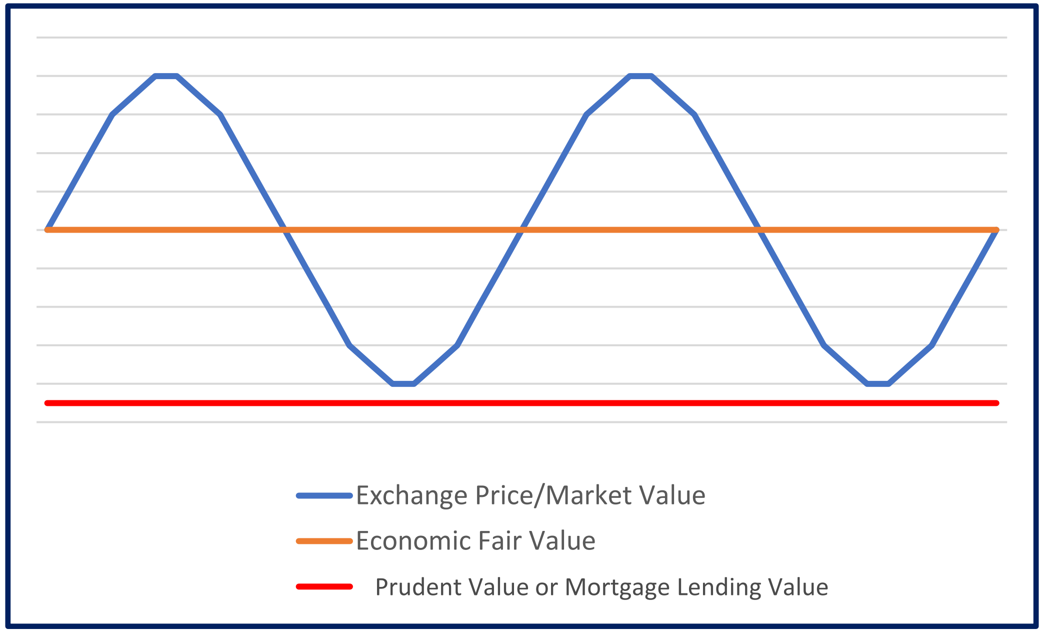
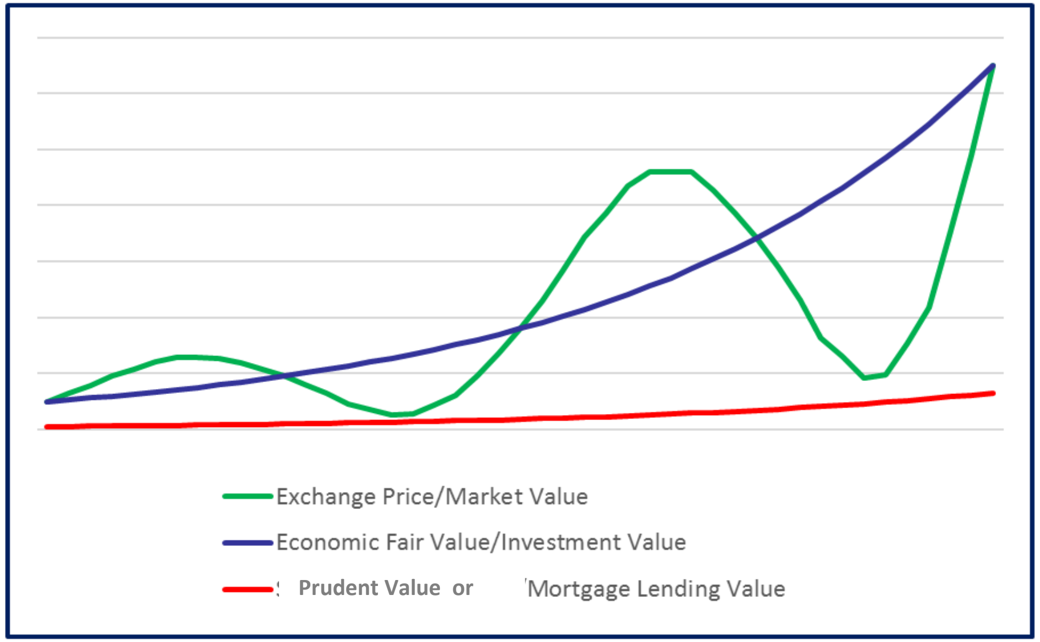
Visualisation of the different valuation approaches





A Stylised View of the Different Approaches to Long-term Value – stationary and non stationary (Source RICS Europe, 2018)

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Implementation of the Prudent Value Principle in the European Union

» The European Union is committed to transpose the Basel III Accord into European law

- 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) provided a first indication through its Policy Advice of 2 August 2019 that the Basel III requirements ...

- will **no longer allow institutions to solely apply a Market Value concept**
- require **additional specifications**
- would allow institutions currently using either the Market Value or Mortgage Lending Value concept to continue to do so, provided that the **input parameters** are **adjusted** and **exclude expectations of price increases**

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Regulatory Proposal of the European Commission published on 27 October 2021

1. The value shall be appraised independently from an institution's mortgage acquisition, loan processing and loan decision process by an **independent** valuer who possesses the necessary **qualifications**, **ability and experience** to execute a valuation

Regulatory Proposal of the European Commission published on 27 October 2021

2. The value is appraised using **prudently conservative valuation criteria** which meet all of the following requirements:

   (i) the value **excludes expectations on price increases;**

   (ii) **the value is 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;

3. The value is **not higher than a market value** for the immovable property where such market value can be determined.

Regulatory Proposal of the European Commission:

Can property values be increased?

» Principle: the value of the property shall be maintained at the value measured at origination

» Exception: restricted upgrade in case of unequivocal increase of value e.g. through energy efficiency renovation

- The value of the property shall not exceed the average value measured for that property or for a comparable property over the last three years in case of commercial immovable property, and over the last six years in case of residential property. Modifications made to the property that improve the energy efficiency of the building or housing unit shall be considered as unequivocally increasing its value.

Underlying Valuation Assumptions

- The prudent value approach shall be compatible with the major valuation models such as market value, investment value (through-the-cycle) or mortgage lending value (under-the-cycle)
- The prudent or long-term value approach applies to each individual property (not at market or portfolio level)
- The rationale of 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.

The Need for Additional Specifications

- The baseline scenario is:
  - absence of a definition of ‘prudent value’
  - probably no new base of value
  - no harmonisation of valuation methodologies across countries
  - national specificities (market structures, data sources, professional best practice standards etc.) must be respected
- International Valuation Standard Setters (IVSC, RICS and TEGOVA) tend to agree that the proposal might turn out as a **discounted or adjusted Market Value approach**

How to determine Market Value Adjustments ?

- Application of discounts
  - Flat rate discount of 5%, 10% or 20% across all (local, regional, national) markets and all property types? Probably not best practice.
  - Flexible discounts depending on the economic environment, market cycles, location, property types etc.? Probably better suited to reflect long term real estate risk.
- Measurement of discounts: potential input parameters (not exhaustive)
  - Macro-economic criteria: inflation & unemployment rates, vacancy and stock levels, indicators of depreciation in value of assets through time etc.
  - Property specific criteria: use of longer term/past trend data such as value volatilities & time series covering rental income, capitalisation rates, capital values etc. of the specific property
- Transparent real estate markets and availability of individual property data would be required

The Challenges ahead

» Prudent or long-term value might require some 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
- ➢ how to proceed in more opaque and/or emerging 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, capitalisation rates or property yields?

» Additional guidance is necessary at national level to address country specific issues (data issues, market structures etc.)

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