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European Valuation Standards Board interprets 'prudently conservative valuation criteria' that the amended Capital Requirements Regulation is set to introduce alongside Market Value

The legislative debate on revision of the Capital Requirements Regulation is not yet over, but all signs are that the Council of Ministers and the European Parliament will rubberstamp the European Commission's transposition of the Basel III concept of 'prudently conservative valuation criteria' into the CRR. We are to understand that the international and European banking supervision authorities consider this to be a necessary further safeguard against valuation-induced systemic bank risk.

The CRR lays down that in valuation according to 'prudently conservative valuation criteria', "the value excludes expectations on price increases". The EVSB addresses the issues arising from this in the contexts of:

- *Valuation under the income approach*
- *Using the direct capitalisation model*
- *Valuations carried out by means of a DCF model*
- *Treatment of rental increases*
- *And the developer's profit in the residual method of valuation*

The second CRR requirement for appraisal according to 'prudently conservative valuation criteria' is that "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". Here the EVSB highlights issues of:

- *Distinguishing between 'market value' and 'market price'*
- *Assessing the sustainability of the value over the life of the loan*
- *The impact of oversupply of a particular type of property on prices and value*
- *The impact on future value of declining population of a given locality and other negative factors changing the surroundings of the real estate*

Briselē, 27.10.2021.
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2021/0342 (COD)

Priekšlikums

EIROPAS PARLAMENTA UN PADOMES REGULA,

ar ko Regulu (ES) Nr. 575/2013 groza attiecībā uz prasībām kredītriskam, kredīta vērtības korekcijas riskam, operacionālajam riskam, tirgus riskam un pašu kapitāla minimālajai robežvērtībai

(Dokuments attiecas uz EEZ)

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Appraisal of value using 'prudently conservative valuation criteria' under the amended regulation (EU) No 575/2013 (Capital Requirements Regulation) Article 229(1)

European Valuation Standards Board preliminary commentary pending final agreement on the Regulation by the Council of Ministers and the European Parliament

1 March 2023

Article 4 (74a) *'property value' means the value of immovable property determined in accordance with Article 229 (1)*

Article 229 (1) is replaced by the following:

The valuation of immovable property shall meet all of the following requirements:

> *a) 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;*
>
> *b) 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;*
>
> *c) the value is not higher than a market value for the immovable property where such market value can be determined. The value of the collateral shall reflect the results of the monitoring required under Article 208(3) and take account of any prior claims on the immovable property.';*

Article 229 of Regulation 575/2013 on prudential requirements for credit institutions and investment firms is titled '**Valuation rules for recognised collateral other than financial collateral**'.

Sub-paragraph a) of paragraph 1 of Article 229 sets out the requirements to be met by the valuer of the property so that the valuation may be relied upon for mortgage loan purposes. Reference to a "valuer" indicates the need for a valuation performed by a physical person and not merely the result generated by an automated valuation model (AVM), albeit this does not exclude the possibility of the use of an AVM as a tool to assist the valuer with the necessary qualifications, skills and experience.

Reference to *necessary qualifications* suggests the need for a valuer to satisfy any legal requirements to practise as a valuer in an EU Member State. In the absence of such legal regulation, the valuer's qualification should be in accordance with prevailing market practice in the Member State concerned. The valuer should in such a case possess the qualifications that real estate valuers are typically expected to possess by participants in the relevant property market.

Article 229 emphasises the requirement that both the valuer and the valuation be independent of the mortgage loan application and decision-making processes. Thus, a valuer performing a real estate valuation for bank loan purposes can be neither involved nor interested in the outcome of the loan decision-making process. Any valuer employed by a company involved in the loan decision-making process must also be disqualified.

Article 229(1) a) b) and c) refer to the 'value' of the property, which is clearly distinguished from the 'market value' of the property in c). Whilst these are not identical concepts, the valuation methodology described in European Valuation Standards 2020, Section II – Valuation Methodology is applicable to the assessment of both types of value.

Paragraph b) requires the use of "*prudently conservative valuation criteria*" as follows:

i) the value excludes expectations on price increases;

This exclusion relates to asking prices quoted in the property market or forecasts at the date of valuation but which may be higher than supported by market evidence immediately prior to the valuation date. The valuer should therefore not reflect any such expectation of an increase in sale prices in the future. This does not, however, preclude the possibility of the valuer having regard to increasing prices, in a comparative approach valuation, as observed between the dates of recorded sales transactions of comparable properties and the date of valuation. However, such rising trends should not be forecast beyond the valuation date.

Under the income approach, the valuer will be aware that sale prices of properties generating or capable of generating an income are influenced mainly by the level of such income and yields, the latter reflecting investment risk. All other things being equal, an increase in income generally results in an increase in price. A similar effect is produced by a fall in market yield at a sustained level of income. However, changes in these two factors can cancel each other out (fully or partially) in their effect on a sale price. They may also exacerbate each other's effect leading to higher sale prices as in the case of rising incomes and falling yields. For this reason, valuers adopting an income approach should consider the overall impact of all their valuation assumptions in order to be able to assess whether those assumptions are leading to the inclusion in the valuation of an expectation of future increases in property sales prices beyond such expectations based on market evidence immediately before the date of valuation.

It should be recognised that an income approach valuation by its very nature does reflect the market's expectation of future rental and capital growth. Provided therefore a valuation does not reflect assumptions which are even more optimistic than supported by market evidence at the date of valuation, a valuer can safely assume that her or his valuation meets the exclusion of sub-paragraph i) above.

In using the direct capitalisation model, the valuer assumes a level of income equal to the level obtainable for the property at the valuation date. This level will not of course be expected to remain constant over time in the future. Therefore, the risk of it falling or the expectation of it rising is reflected in the so called *All Risks Yield*. As this rate is most often derived from market analysis, it represents the perception of the risk of declining value or expectations of increases common amongst market participants. In arriving at the '*value*' of the property, valuers should however ensure that their derived capitalisation rate (all risks yield) is indeed supported by the prevailing market sentiment and not over optimistic in anticipation of higher market prices in the future.

The situation is somewhat more complicated in the case of **valuations carried out by means of a discounted cash flow (DCF) model** whether in the form of an implicit or explicit cash flow. In both these cases, the expectation of market participants of future rent increases may be reflected in the valuation during the cash flow period. In an implicit cash flow, this will generally mimic a simple capitalisation approach by applying an '*All Risks Equivalent Yield*'. In an explicit cash flow, expected future rental growth is reflected in the cash flow projection. In the latter case, attention should be paid to the interrelationships between the individual valuation assumptions but again, in arriving at the '*value*' of the property, valuers should ensure that their projected cash flows, discount rates and exit yields are supported by the prevailing market sentiment and not over optimistic in anticipation of higher market prices in the future.

Treatment of rent increases

When applying the income approach, the valuer should furthermore pay particular attention to any contracted indexation of rents or other income generated by the property, being another factor shaping the value of the property and sale prices. Since rental indexation is an element of the legal status of the property it should, in principle, be excluded from consideration of its possible impact on the expectation of price increases in the valuation. That said, a certain element of forecasting of the level of indexation over the remaining term of a lease will be needed. In eliminating the undesirable inclusion in the valuation of the expectation of an increase in the sale price of the property as a result of such indexation, the valuer may decide to adopt a future indexation at a level lower than (a) the inflation target of the relevant central bank or (b) the current level of the given index (if it is lower than the inflation target of the central bank).

A separate issue is the possible assumption in a projected cash flow of the rental indexation at the end of the term of the leases.

When projecting future rental increases at the end of lease terms, the elimination of the assumption of an increase in the sale price of the property in the market may be required. Again, the valuer should consider such an assumption holistically together with the other valuation assumptions made to assess, as described above, whether such a set of assumptions does not indirectly lead to the inclusion of an expectation of price growth in the valuation.

The developer's profit in the residual method of valuation

In the case of a residual method of valuation, it should be noted that the developer's profit taken into account in the valuation reflects the level of risk of running a given construction project. Part of the risk of this type of project is related to the risk of a decrease or the expectation of an increase in the Gross Development Value of the completed development between the date of the valuation and the date of the actual completion of the development. An example of this is the sale prices of apartments, which may vary in a local market between the date of valuation and the date of completion. If there is an expectation that the sales prices of the apartments will be higher in the future, thereby translating into a higher value of the completed residential development, market participants may, at the valuation date, commonly accept a level of developer's profit that is lower than would be the case in the absence of expected increases in the prices of the apartments in the future. In such a situation, in order to exclude expectations on price increases a valuer should consider the justification for increasing the level of developer's profit assumed in the valuation above that which is typically observed in the market on the valuation date.

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;

The second of the prudent valuation criteria refers to "*market price*". This should be understood as the price agreed or paid for the property. This criterion requires an adjustment to be made to the estimated '*value*' to reflect any risk that this '*market price*' may be significantly higher than the value that would be sustainable over the life of the loan. However there appears to be no need for the valuer to prove that the '*market price*' will indeed be significantly higher. What is important is the identification of the risk of this occurring, as indicated by the words "*may be significantly higher*". The required adjustment is mandatory if it is not possible to exclude such risk. This is likely to be difficult in most cases. Ultimately any '*adjustment*' made to the '*value*' is reliant solely on the well-argued expert opinion of the valuer based on her/his knowledge of the local market. Subparagraph ii) does not impose upon the valuer the need for a valuation which is separate from the assessment of "*value*" but an arithmetical '*adjustment*' to the latter.

For the purposes of analysing whether the prudent valuation criterion under this sub-paragraph is met, the valuer should be advised by the lending institution on **the length of the loan period**. It should be noted that, in most cases, as the term of the loan increases, the risk of changes in the value of the property occurring over time increases, hence the sustainable value of the property may be lower in the case of longer-term loans.

An assessment of the risk that the current 'market price' of a property may be significantly higher than the value that would be sustainable over the life of the loan may be based on an analysis of the market in the context of its cyclicality. If the market price of the property was agreed when the market was at the peak of the market cycle, there is likely to be a risk that the price will be significantly higher than the value that could be sustained over the term of the loan. By contrast, if the price was agreed when the market was at the bottom of the market cycle, there is probably little such risk.

Apart from the analysis of where the market is in the cycle, all other known factors should be taken into account in the assessment of the described risk. In particular, the oversupply of a particular type of property may lead to a decrease in prices in the future and thus to a decrease in the value of the assessed property in the future.

Another factor of this type may be, for example, the **declining population** of a given locality observed on the local market, which may translate into a weaker demand for residential real estate in the future and thus a decline in the value of the property being appraised. This group of factors also includes all **negative factors changing the surroundings of the real estate**, e.g. construction of a burdensome industrial plant in the neighbourhood, which may reduce the attractiveness and value of the assessed property in the future. The catalogue of such factors to be considered when performing a valuation is open-ended and may vary significantly depending on the local market or the type of property being valued. However, it is certainly crucial that the valuer have an understanding of the local market and analyse it for the purposes of the valuation being carried out. This analysis may be carried out personally by the valuer. However, it should also be considered reasonable to use reliable studies from reputable firms and research centres specialising in market analysis.

Pursuant to paragraph c) of Article 229(1), if a market value can be determined for a property, the '*value*' of the property described above must not exceed that market value. In order to comply with this condition, valuers should always assess both the "*value*" of the property and its "*market value*".

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