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Bank lending valuations and mortgage lending value

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RICS professional standards and guidance

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RICS code of practice (CoP)	A document developed in collaboration with other professional bodies and stakeholders that will have the status of a professional statement or guidance note.

1 Scope

1.1 General

This guidance note is primarily directed at those providing valuation services within or subject to EU jurisdictions for bank-lending purposes, in particular where the provision of a mortgage lending value (MLV) is requested. While designed for reference by RICS members, it may also assist understanding of the underlying issues by users and other stakeholders – borrowers, lenders and regulatory authorities.

The guidance note covers:

(a) 'Sustainable' or 'long-term' value methods (section 2 and Appendix A)

(b) the main definitions of MLV: EU, Germany and Spain (section 3) and

(c) the role of the RICS valuer (section 4).

In addition, this guidance note identifies some of the current developments in Europe concerning long-term valuations that are not currently part of the bank lending valuation process but may be required in the future.

1.2 Introduction

Valuation practice guidance – application 2 (VPGA 2) of the *RICS Valuation – Global Standards 2017* (the 'Red Book') on valuation of interests for secured lending states that:

'Market value is the basis of value widely used for valuations or appraisals undertaken for secured lending. However, in some jurisdictions alternative bases may be recognised or expressly required, for example, as a result of statute or regulation, 'mortgage lending value' being one example.'

RICS advice is that market value (MV) remains an important and integral component of any assessment of the security of any individual property for secured lending purposes. Although this guidance note recommends that MV is provided for all secured lending valuations regardless of any other method of valuation used, the Red Book 2017 does not mandate that MV is provided in all cases.

This guidance note addresses primarily the application of the main alternative valuation to MV, which is MLV.

MLV is not the only alternative valuation for bank lending valuations. In the aftermath of the global financial crisis (GFC), the banking process has come under increased scrutiny at global, regional and national levels. Regulatory authorities have discussed various methods by which they can introduce measures to address significant problems identified in the banking system and help to prevent future failures. Appendix A includes these discussions, which may in the future lead to other bases of valuation or alternative interpretations of existing bases being developed.

Real property accounts for a significant portion of bank lending. Primarily it is used as security for loans, and valuations of that security are an important part of the secured lending process, both at the commencement of the loan and – particularly for commercial property – during the life of the loan. In rising markets, risk may appear to reduce, but when significant property market downturns lead to loan amounts exceeding realisable values on a widespread scale, as occurred during the GFC, the banking system comes under severe stress. The GFC exposed some serious weaknesses, which were not confined to those banks that failed. It is therefore not surprising that the role of property and property valuation in the bank lending process is being scrutinised by regulatory authorities and central banks.

Within this context, the MV basis of valuation has come under increased scrutiny by regulators and other approaches to secured lending valuation are being assessed by organisations within banking, finance and real estate (see Appendix A). This guidance note seeks to identify these issues by both discussing the wider context of alternative approaches and giving specific guidance on the most established alternative long-term valuation, MLV.

2 Concepts and definitions of value for bank lending purposes

International Valuation Standards (IVS) identifies market value (MV) as the normal appropriate basis of valuation for secured lending purposes. Long-term sustainable value is an alternative valuation concept not recognised within mainstream economics, but it has a long history within property valuation for secured lending (there are arguments whether long-term value is a value concept, basis and/or method but that does not change the specific guidance in this guidance note, so that discussion is not developed here).

This paper will use the term 'long-term value' rather than 'long-term sustainable value' from this point onwards. Long-term value does not mean that the value of the property can last through time. Long-term valuations are not static, must have a date of valuation and should not be assumed to last for any period of time. Long-term value is not currently defined within IVS but has been in use in a number of countries. With the increasing amount of cross-border investment and lending, this approach to valuation is now required in many other countries.

The MV concept and definition is widely adopted around the world for secured lending purposes. The definition is set out in the IVS General Standards (2017 edition), IVS 104, paragraph 30.1 and in the Red Book 2017, valuation practice statement (VPS) 4, section 4:

'The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.'

The concept is clear and objective: the identification of the most likely exchange price in the market place at a particular point in time. The purpose is to mark-to-market and the valuation does not seek to do anything other than identify this price at this specific point in time. It has theoretically no shelf life beyond that time and does not purport to give any further information concerning the value of the property during the lifetime of any loan granted.

The most well-known application and established sustainable long-term value is mortgage lending value (MLV). Although not defined within IVS, it is defined in legislation in some countries and is used in the Basel Accords. A definition is set out in the European Union Capital Requirements Regulation (CRR) Article 4(74):

'The value of immovable property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property.'

MLV is not an attempt to create a conservative market value or a market value under restrictive marketing conditions. It is a fully fledged alternative model with different underlying characteristics. It may, however, have some or many of the same or similar inputs as a MV and uses similar valuation methods, such as the investment approach and depreciated replacement cost.

Both MV and MLV have been heavily criticised as the valuation bases for bank lending and their limitations are discussed in more detail in Appendix A, which also sets out alternative long-term value models being discussed around Europe. Valuers need to take notice of these developments.

But, at the time of writing, MV remains the most widely used basis of valuation for secured lending purposes. Clients are increasingly expecting an alternative long-term valuation approach to be applied and currently this is MLV. Given that the most widely used and understood basis of value is MV, this guidance note recommends that where an alternative basis to MV is requested, MV is also provided. However, it should be noted that the provision of MV is not mandatory within the Red Book 2017.

This guidance note gives best practice advice on the application of MLV.

3 Mortgage lending value

3.1 Regulations

3.1.1 The European Union

Alongside the definition of mortgage lending value (MLV), the Capital Requirements Regulation (CRR) also states that (Article 229, paragraph 1):

'Institutions shall require the independent valuer not to take into account speculative elements in the assessment of the mortgage lending value and to document that value in a transparent and clear manner.'

The main reason for requiring a MLV is banks seeking a privileged status for capital backing for real-estate secured loans where EU Member States have laid down criteria for the assessment of MLV. This was the main driver for the European Banking Authority receiving delegated authority to determine draft regulatory technical standards for MLV for those EU Member States where MLV is used. They identify three situations where the use of MLV is included in the CRR:

- within the standardised approach (Articles 124, 125 and 126)
- credit risk mitigation (Article 229) and
- in the large exposures framework (Article 402).

In addition, MLV is also linked to capital requirements in the form of covered bonds (Article 129).

3.1.2 European practice

It is difficult to categorise countries into those that use market value (MV) and those that use long-term value as many operate both practices according to the particular valuation purpose and/or client. Countries that currently rely on MV or similar estimates to set loan to value (LTV) limits include:

- Belgium
- Bulgaria
- Cyprus
- Denmark (the largest covered mortgage-backed covered bond market in the world)
- Finland
- France
- Greece
- Iceland
- Ireland
- Italy
- Latvia
- The Netherlands
- Norway
- Portugal
- Romania
- Russia
- Sweden
- Turkey and
- the UK.

Specific country regulation must be followed and, in some cases, this may prescribe MVs subject to restricted marketing or other assumptions.

Countries that make reference to a longer-term value, or more specifically MLV, within regulations include:

- Austria
- Czech Republic
- Germany
- Hungary
- Luxembourg
- Poland
- Slovenia and
- Spain.

Romania has guidance on MLV within national valuation standards but, at present, valuers are directed to MV. The purpose of this list is to point out where valuers are more likely to be asked for an MLV or similar long-term valuation and where it is likely to be within a regulatory framework.

In addition to this, due to cross border activity, clients can be operating in many countries, meaning MLV can be requested in all countries. This is the case especially for German banks. It is beyond the scope of this guidance note to investigate the regulations underpinning the production of valuations in different countries. It is the responsibility of members asked to undertake MLVs to satisfy themselves that they are following any country-specific rules and regulations or those set by the client. However, as MLV is a well-established concept in the covered bond market and mortgages make up a substantial proportion of that covered bond market, it is useful to identify those countries with substantial assets in those markets and the framework that exists for undertaking MLV in those countries.

3.2 MLV in individual countries

3.2.1 Germany

The German mortgage banks have the most well-established set of guidelines for undertaking MLV.

The Association of German Pfandbrief Banks dates MLV back to the German *Mortgage Bank Act* of 1900, but it was during the first decade of this century that the regulations were modernised (*Pfandbrief Act* 2005 and the Regulation on the *Determination of the Mortgage Lending Value* (*Beleihungswertermittlungsverordnung* (*BelWertV*)) of 1 August 2006). These regulations set out how MLV should be undertaken and the rules over which valuers can undertake these valuations.

There are two main uses of MLV in Germany identified by the Association of German Pfandbrief Banks:

1. By Pfandbrief Banks that want to include real-estate secured loans in the cover pool of a Mortgage Pfandbrief (covered bonds). Under sections 12 and 16 of the German *Pfandbrief Act*, these banks must determine the MLV of the property and not more than 60% of this MLV may be refinanced through the issuance of Mortgage Pfandbrief.
2. The second main use relates to the EU CRR directives set out in section 3.1.2.

Section 16 of the *Pfandbrief Act* regulating German mortgage banks defines the assessment of MLV as a value that cannot exceed the value with the above attributes and more importantly cannot exceed the MV:

'The mortgage lending value must not exceed the value resulting from a prudent assessment of the future marketability of a property by taking into account the long-term, sustainable aspects of the property, the normal regional market conditions as well as the current and possible alternative uses. Speculative elements must not be taken into consideration. The mortgage lending value must not exceed the market value calculated in a transparent manner and in accordance with a recognised valuation method.'

The German regulations not only define the valuation, they are also prescriptive over how it should be undertaken, even down to the prescription of specific inputs into the valuation. For example, Annex 1, 2 and 3 of the *BelWertV* 2006 set out bands of inputs to be used in the valuation. Annex 1 deals with costs such as management, maintenance, and loss of rental income, Annex 2 sets out bands of allowable life cycles for specific types of building and Annex 3 sets out bands for the level of capitalisation rate to be used in the valuation.

3.2.2 Spain

The second largest covered bond market adopting MLV is Spain. The *Ministry of Economics Order* ECO/805/2003, dated 27 March, on *Standards for valuation of real estate and certain rights for certain financial purposes*, sets out detailed valuation principles. It amended a previous 1994 order and one of the major reasons for the new order was to take into account long-term value. It defines mortgage value or value to effect mortgage credit (VH) as:

'the value of the property determined by a prudent valuation of the future possibility of trading with the property, taking into account the long-term durable aspects of it, normal and local market conditions, its use at the time of appraisal and their corresponding alternative uses. The determination referred to in the previous section shall not include speculative elements.'

This definition allies closely with the EU definition of MLV. Article 2 and Article 45 are particularly relevant as they set out the scope of application of the order and details of how the value models are to be applied to valuations for mortgage markets and for pension funds. ECO/805/2003 does not distinguish definitively between MV and MLV and, therefore, the mortgage value approach is less prescriptive than for the German Pfandbrief MLV.

3.2.3 Regulations in other countries

Other national regulations or codes setting out valuation principles and process in various levels of detail include:

- Austria (*Mortgage Banking Act* (Law of 7/13/1899) last amended 2010)
- Hungary (*Decree of the Minister of Finance* number 25/1997 and the *Decree of the Minister of Agriculture* number 54/1997)
- Luxembourg (*Commission de Surveillance du Secteur Financier* (CSSF) Circular 01/42))
- Poland (*Act on Mortgage Bonds and Mortgage Banks* of August 29, 1997; *Journal of Laws* no. 99, item 919 (*List Zastawny Act*)) and
- Portugal (*Notices and Regulatory Instruments of the Central Bank* (*Avisos e Instruções*), 5/2006).

Valuations for secured lending and other financial purposes are, therefore, underpinned by different frameworks in different countries. These frameworks need to be researched for the particular country and for the particular task. There is a different level of prescription within each of these jurisdictions, with the German MLV having the most highly-developed framework. It may be appropriate to use some of the more prescriptive inputs and applications of the model in one jurisdiction than in another jurisdiction, and clients may expect some crossover, especially owners from outside the home country who may be used to particular approaches. It is the valuer's responsibility to identify the appropriate inputs into the valuation and manage expectations of clients.

There is some discussion over the issue of whether under any circumstances MLV can exceed MV. In some jurisdictions (for example within the German *Pfandbrief Act*) it is not allowed under the regulations. Some long-term valuations are designed to identify both under and over-pricing so, in those cases, MLV could exceed MV quite regularly in cyclical markets. MLV is designed generally to be a risk management tool and it is expected it will very rarely exceed MV.

4 The role of the RICS valuer in relation to mortgage lending value

4.1 Qualifications

RICS members have, in some cases, raised doubts about their ability to act in response to requests from clients for advice on mortgage lending value (MLV). Subject to satisfying any specific requirements regarding qualification and competence in individual jurisdictions, it is expressly confirmed that there is no objection to suitably qualified and experienced RICS valuers providing advice on MLV.

Most aspects of MLV do not need specialist market knowledge not available to the suitably qualified RICS member. However, it is a different concept of value to market value (MV) and the valuer needs to make sure they understand this valuation, the underpinning regulation where applicable and the required approach, before accepting an instruction.

Formal training and certification may be required under certain jurisdictions to carry out MLV and credit institutions must not accept a valuation until they have satisfied themselves that valuers have met the necessary requirements. An obvious example is the certification of valuers carrying out valuations for German banks both inside and outside Germany by HypZert Gmbh.

4.2 Valuation

Where RICS members carry out an MLV:

- The MLV definition used must be explicitly stated (for example, see the EU definition in section 3.1) in the terms of engagement and in the valuation report and noted as a departure (albeit an acceptable one) from the RICS Red Book 2017, unless mandatory in the particular context or jurisdiction (see PS 1.6.3).
- The methodology applied must also be clear and explicit – the exact level of detail to be set out is a matter of judgment for the valuer in individual cases.
- The valuer must make it clear that MLV is distinct from MV and is not to be confused with it. It is not a MV under special assumptions, including restricted marketing.
- The RICS Red Book 2017 applies to MLV work. Section 1 of VPS 4 should not be taken to exclude the provision of MLV advice by an RICS valuer. It gives guidance on how to approach a valuation using a valuation basis not specifically defined in the Red Book 2017.
- The MV should be provided alongside any MLV if the valuer believes it will help the client understand the MLV. This guidance note recommends MV is assessed and reported on every occasion.
- Where similar inputs are used in both MV and MLV, differences in interpretation of those inputs must be highlighted in the valuation report to document MLV in a clear and transparent manner. For example, differences may occur between market rent, existing rent under leases and sustainable rent and between capitalisation rates used in the two different methods.

RICS does not prescribe a valuation method. This may be prescribed in country specific regulations or within the instructions of clients. In the absence of any prescription within regulation or instructions, the approach to MLV may vary depending on different interpretations and applications of methods. Given these possible variations in approach to the valuation, the MLV method adopted requires an increased level of description of the method so the valuation can be understood by the user. In Germany, the method has been subject to significant prescription as outlined in section 3.2.1. But prescriptions in one country could be inappropriate for other countries, so MLV requires additional guidance on the method at a country-specific level. In many countries that guidance is not yet available, so this guidance note sets out some defining common factors within MLV.

Common factors:

- The usual internationally recognised methods of valuation apply to MLV. The three major applications identified by the European Mortgage Federation (EMF, 2012) for MLV are the: income method, comparison method and depreciated replacement cost method. MLV is often applied by reference to more than one approach for an individual property; for commercial property this would normally include an investment-based valuation method and a value based on depreciated replacement cost.
- The approach requires the valuer to attempt to eliminate short-term market volatility. This principle underpins all aspects of the method. Sustainability of any comparative values needs to be taken into account. Information and references to the volatility in specific markets is a pre-requisite of a well-documented valuation.

- Site values and building values are often assessed separately with site values based on a market price, subject to an assessment of where land values are within any particular cycle. Building values are based on a limited life cycle and must be depreciated accordingly. These building lives can be prescribed within legislation but where they are not prescribed, the valuer needs to take a view on the life cycle of the building and the age and quality of any existing buildings.
- Capitalisation rates should also be based on long-term sustainable rates and these are not necessarily the current market capitalisation rates. One approach is to use market capitalisation rates unless they fall below prescribed floors. Where they are not prescribed, the valuer should be aware of how capitalisation rates have in the past fluctuated for the particular market and not use rates that are significantly below these longer-term trends.
- Rents and rental values should be sustainable – they should be based on current market levels but reduced where letting markets appear to be under-supplied and market rents unsustainably high. Over-renting is normally ignored in an MLV valuation. No attempt has been made to specify sustainable rental values in jurisdictions where other inputs have been enshrined in legislation. This may be because, in these jurisdictions, rental values have been historically measured to show low cyclical movements. In jurisdictions where markets have traditionally been measured as having more cyclical movement in rental values, the use of current market rents as a sustainable rent within an MLV would produce significant volatility in the MLV through time. This is particularly apparent where any cyclicality in values is caused by demand and supply mismatches in occupier rather than investment markets. In cyclical rental markets, it is particularly important to consider the basic economic indicators of demand and the supply side characteristics of the location and reduce the rental value input to a more sustainable level where rental markets are perceived to be overpriced.
- As with all valuations, irrecoverable costs should be deducted. In some jurisdictions, these are specified in legislation but these may be inappropriate for the particular market. Where they are not specified in any local legislation or guidance, appropriate deductions should be based on actual lease structure and cost of occupation wherever possible.

MLV is normally based on the current use of the property. It should only be calculated on the basis of an alternative use when that permission has been obtained or if there is a proven intention to renovate or change the use. The valuation of land for MLV can be undertaken using the usual methods, including residual methods, but, given the added uncertainty surrounding some aspects of land valuation for development, inputs must be specified at a level that passes the test of ‘taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property’ (CRR Article 4(74)).

5 Conclusion

This guidance note has set out the principles for producing mortgage lending value (MLV).

It has made reference to the fact that MLV is applied differently in different countries, and also to some specific applications and the more basic principles underpinning the provision of an MLV. Not all countries have a system of MLV or another form of long-term value in place, but due to cross-border investment and lending (for example, German banks), RICS members in any country can be asked to provide an MLV.

There is no objection to suitably qualified and experienced RICS valuers advising on MLV, provided they take this guidance note into account and at all times specify which definition of MLV is used. The approach taken needs to be documented in a clear and transparent manner. An MLV should be provided in conjunction with a market value (MV), with the differences clearly explained where the valuer feels it necessary to put the MLV into context. The valuer must be sure they comply with any regulatory requirements before they accept any instruction to undertake a MLV.

At the time of writing, MV remains the most widely used basis of valuation for secured lending purposes but it has limitations. Clients are increasingly expecting an alternative long-term valuation approach to be applied and at present the only developed approach is MLV. However, MLV has also been heavily criticised. As alternative long-term value bases are being investigated by governments, central banks and valuer organisations worldwide, it is therefore felt appropriate to add an addendum to this guidance note. This addendum does not impact current practice but sets out some of the more conceptual issues. It identifies other long-term value methods being tested around the world with the objective of informing RICS members and other stakeholders in this area of practice of these developments as at the end of 2017. RICS members need to keep abreast of these developments, which may have a significant impact on what they are expected to deliver in the future.

Currently, given that the most widely used and understood basis of valuation is MV, RICS recommends that where a long-term value is requested it should be provided in conjunction with a market valuation. However, the Red Book 2017 does not mandate the provision of MV in every case where an alternative long-term valuation method is used.

Appendix A: Long-term valuations

There is much global activity in this area of practice and it is therefore appropriate to identify the potential changes that may take place and impact both the providers and users of bank lending valuations. At present, valuers are not being asked to undertake alternative valuation approaches to market value (MV) other than mortgage lending value (MLV). It would therefore be inappropriate to include this discussion here, but stakeholders in this process should be aware of the potential for significant change in the near future.

As indicated in section 1.2, in the post-global financial crisis (GFC) era, regulatory authorities and other stakeholders have paid much more attention to property and property valuation. Over-lending secured on property markets, both residential and commercial, was identified as a major cause of financial market instability. In this post-GFC era, some of the discussion and research has been aimed at identifying alternative valuation approaches for secured bank lending purposes based on long-term value. Recent developments in this field include the European initiative to develop a long-term sustainable value, originating from Germany, and long-term value discussions in the UK as follow-up to a 2014 report on *A Vision for Real Estate Finance in the UK*. More information can be found in the RICS insight paper *The Future of Valuations* (2017) (www.rics.org/uk/knowledge/research/insights/the-future-of-valuations/).

Some of this work has concluded that both MV and MLV have major issues. The major issue with MV is that it is pro-cyclical and encourages lending in over-priced markets and discourages lending in a fallen market. This assumes an absence of any counter-cyclical measures being applied to loan to value (LTV) or loan to income (LTI) ratios. It is argued that the use of unadjusted LTV ratios based on MV in a rising market allows lenders to increase the lending on individual assets, further fuelling the market prices, which further allows increased lending. Therefore, if MV acts pro-cyclically, a lender requires a counter-cyclical measure that reduces the levels of lending to individual assets – and thus associated risk – when prices are rising above their 'equilibrium' levels and encourages lending when property values are below equilibrium levels.

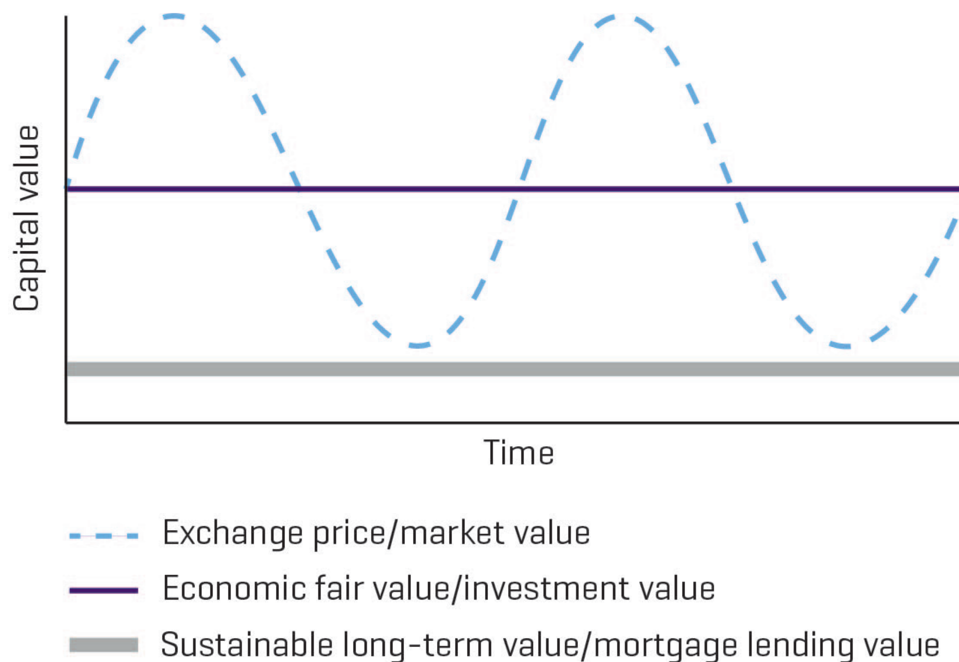
MLV restrains lending in an over-priced market but tends to value at less than MV. Some regulators feel this acts against the need to stimulate an economic recovery by restricting lending in fallen markets, which may actually be under-priced. This is denied by supporters of the MLV approach who would point to the fact that MLV and MV are much closer in an under-priced market and that would encourage both lenders and regulators. Another issue with MLV is that it is represented as a risk management tool, which gives some protection through time. But the valuation itself will move through time as it uses some market inputs. *The RICS insight paper Future of Valuations* illustrates that movement through time and MLV should therefore not be represented as having a shelf life beyond the date of valuation. It may help restrict the amount of lending, causing loans to be better secured through subsequent cycles, but the valuation itself is not static through time.

Notwithstanding these conflicting views about the characteristics of the model, the lack of confidence in certain quarters concerning both MV and MLV has prompted a search for a counter-cyclical long-term valuation model that identifies the underlying, logical price. This type of model has been termed 'fair value' in the 2015 IPF Short Paper, No. 24, *What is Fair Value*? (http://bit.ly/2liheUC). Given the possibility of confusion with fair value as used in accounting, it is termed economic fair value in this appendix.

Over and under-pricing can be characterised by the difference between this economic fair value and MV.

Figure 1 identifies the general shape of the three alternative valuation approaches and indicates the exchange price concept and MV definition following market prices through the cycle, and the economic fair value threading an equilibrium value through the cycle. The MLV is more difficult to characterise and could be similar to the economic fair value concept but, in many jurisdictions, is always below the MV irrespective of the cycle. Note that MLV always being below MV is arguable, but it would be the case where, for example, *BelWertV* guidelines were used for the determination of MLV under the *Pfandbrief Act* in Germany. In exceptional circumstances in certain jurisdictions, MLV could conceivably be above MV but it would be unusual.

Figure 1: A stylised view of the different approaches to long-term value



Due to its pro-cyclical nature, MV alone is considered by some as an inappropriate basis for secured bank lending valuations. Economic fair value identifies both under and over pricing and, therefore, can be used to restrict lending in over-priced markets and encourage it in under-priced markets, acting counter cyclically. It is, however, relatively complex to apply and data requirements are also demanding (so far in this debate it has been characterised as being a long-term value using a growth explicit discounted cash flow approach).

The concept of a long-term value, forming the basis for making lending decisions and monitoring loan performance, is attracting support from a growing number of stakeholders, including central banks with financial stability remits. At present, MLV is the only long-term value concept that has been developed and applied within the secured lending arena and this guidance note gives advice on applying this long-term valuation model. However, a variety of other stakeholders in real estate finance are investigating other long-term value concepts as part of the post-GFC financial stability agenda.

These and other initiatives may change the principles behind this guidance note and it is the responsibility of readers and RICS members to ensure they are up-to-date with developments impacting valuations that post-date this publication. In view of the activity, RICS members should expect significant developments in this area across different countries in the foreseeable future.

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