Operationalising the 'Property Value'

19 October 2023

I. Background

In the context of the finalisation of the Basel III Reforms, in 2017 the Basel Committee on Banking Supervision (BCBS) addressed the issue of property valuation in its Final Report by identifying a new definition of value:

"Value of the property: the valuation 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 of 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…"

At the time of writing, it is our understanding that the final text implementing the Basel III definition into the new Article 229(1) CRR is likely to be as follows, subject of course to final agreement and approval of the council and European Parliament:

"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;

(ba) the value is documented in a transparent and clear manner;

(c) the value is not higher than a market value for the immovable property where such market value can be determined.

(d) Where the property valuation is reviewed, the value of the property shall not exceed the average value measured for that property, or for a comparable property, as defined in Article 4(1)(74a) over the last six years for residential properties or eight years for commercial immovable property or the value at origination, whichever is higher.

For the purpose of calculating the average value, institutions shall take the average across property values observed at equal intervals in time and the reference period shall include at least three data points.

For the purpose of calculating the average value, institutions may use results of the monitoring of property values in accordance with Article 208 (3). The value of the property can exceed that average value or the value at origination, as applicable, in case of modifications made to the property that unequivocally increase its value, such as improvements of the energy performance or improvements to the resilience, protection and adaptation to physical risks of the building or housing unit. The property value shall not be reviewed upward if institutions do not have sufficient data to calculate the average value except if the value increase is based on modifications that unequivocally increase its value.

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."

The valuation of immovable property is instrumental for the determination of exposures' risk weights and subsequently the calculation of banks' capital requirements and the concept of the 'property value' is therefore significant for both the banking community and the valuation profession. Against this background, the mortgage industry and valuation professionals have joined forces to determine a series of key components which will support the practical and proportionate operationalisation of this concept, in full alignment with the CRR and with the BCBS' original recommendations:

II. Premise & components of the 'Property Value'

- The use of the market value alone, as currently referenced in Article 208 CRR, will no longer be permissible under the revised CRR. Indeed, according to the revised Article 229 CRR, banks will be required 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"* and furthermore ensure that "*the value is not higher than a market value..".* The third requirement is that the value must exclude expectations on price increases. It is important to underline that the CRR Articles include the terms 'market value' and 'market price'. As the definition of market value is the amount the property should exchange for, subject to certain assumptions concerning timing and buyer and seller behaviour (see Art. 4(76) CRR for full definition), we assume that the terms market value and market price mean the same thing within the CRR Articles.

- It is important to underline that the 'property value' must be operationalised by 1 January 2025 in setting the capital requirement for all new lending and progressively for existing mortgage portfolios in subsequent years. The 'property value' is therefore relevant for several million properties and mortgages. Against this background, the approach must naturally be robust, but it must equally be proportionate and rapidly practicable in order to achieve the operationalisation by the 2025 deadline. The approach should also be appropriately calibrated to facilitate supervision by competent authorities.

- With these considerations in mind, the mortgage and valuation industries have reached the following conclusions which, in our view, provide for a transparent and consistent approach across Europe, whilst necessarily recognising and accommodating inherent differences between national markets:

1. Inclusion of current use of market value in the operationalisation of property value

- The logical and proportionate basis for the determination of the 'property value' is the market value, which remains a transparent, consistent and well-established valuation approach, having been applied by the valuation and mortgage industries across Europe and beyond for decades. The market value is furthermore a robust basis from which to determine the 'property value' since it allows valuers to detect market speculation by using market data and therefore to contextualise the market value in the market cycle.

- From the market value and in full alignment with the Article 229 CRR requirements, it is then possible to derive the 'property value' based on an adjustment to the market value. The combination of the use of the market value as the robust basis for the adjustment and the adjustment itself supports a 'sustainable' value and contributes to the target of the property value not being higher than the market value. This adjusted market value approach is furthermore entirely aligned with the EBA's "Policy Advice on the Basel III Reforms: Credit Risk Standardised Approach and IRB Approach".

2. Methodological considerations for the market value adjustment

- Based on the research undertaken within the industry and for reasons of practicability and proportionality, the mortgage and valuation industries are of the view that this adjustment should be determined at an aggregate geographical and market segment level by, for example, an independent entity within a financial institution, a well-established and independent authority or organisation, or another appropriate well-established and independent body, with national market oversight, using relevant observable market data to identify whether current market values are above long-term trends, providing evidence of the adjustment to market values which would be appropriate.

- In order to ensure appropriate risk sensitivity and to account for the differences between and within property segments at national level, the adjustment approach should enable a sufficient level of flexibility as regards its components and parameters.

3. Independence of the valuer

- As market value will continue to be delivered by an independent valuer, this approach remains entirely aligned with the valuer independence requirements of Article 229 CRR. The adjustment ('property value') needs to be applied consistently across all lending, thus fulfilling the independence requirements automatically, independent of the executing individual.

4. Use of existing national methods that already fulfil the requirements of Article 229

- If other methods/value concepts already exist at national level or based on best practices and international valuation standards that can serve as the starting point for meeting the requirements of Article 229 CRR, e.g. mortgage lending value, then these can be used as an alternative to the market value with adjustment.