

Template for comments

Consultation on the draft ECB Guidance for banks on non-performing loans

Institution/Company

European AVM Alliance (EAA)

ID	Chapter	Section	Page	Type of comment	Detailed comment	Concise statement why you board
1	7 - Coll	Entire Chapter	85 ff.	Clarification	<p>Clarification on Collateral Valuation Methods for Immovable Property</p> <p>The European AVM Alliance (EAA) has carefully analysed the draft ECB guidance to banks on non-performing loans and would like to congratulate the ECB for a well-conceived document.</p> <p>As an association of specialised providers of Automated Valuation Models (AVMs) for the valuation of immovable property, setting the highest industry standards for AVMs in Europe, our response concentrates solely on chapter 7 of the draft guidance.</p> <p>Careful analysis of the proposed text for chapter 7 has led the EAA to the conclusion that there are a number of terms and definitions with regard to different valuation solutions for the collateral of NPLs which lack clarity and appropriate distinctions and in some instances are even misleading. In the EAA's opinion these need further clarification.</p> <p>In particular clarifications – and resulting amendments – are necessary regarding:</p> <ul style="list-style-type: none"> - the current omission of the reference to "statistical methods" in the quotation of paragraph 3 of Article 208 of the CRR in the draft guidance - the resulting confusion between "statistical methods" and "other automated processes" in the draft guidance - the currently implied and misleading sub summation of all "statistical methods" / "other automated processes" under the category of "indexed valuations" in the draft guidance - the current lack of clarity and potentially misleading use of the term "individual" in the definition of "individual valuations" in the draft guidance - the resulting current exclusion of high-quality statistical methods, namely Comparables-Based AVMs, as an additional possible tool for "individual property valuations" in the draft guidance - the arbitrary figure of 300,000 EUR as a threshold for allowing the use of indices and other automated processes for revaluation in the draft guidance <p>In order to achieve greater clarity in these areas, it is necessary as a first step to briefly lay out explicitly the three different fundamental types of property valuations. Since the draft guidance contains the criterion of "individual valuations" (7.2.3) – a point which will be addressed separately in greater detail by the EAA in this response – the three valuation types and their respective subcategories are also distinguished by whether or not they fulfil that criterion. In addition, as the EAA is advocating the clear inferiority of the third type of property valuations set out here, but it is not advocating the equivalence of the first two, the key criterion that can distinguish them, i.e. the ability to enter a property to check its condition, is also captured.</p> <p>[PLEASE SEE ALSO TABLE ON THE WORKSHEET "VALUATION TYPES" ADDED TO THIS FILE]</p> <p>A. Appraiser valuations Valuations undertaken by a qualified appraiser</p> <p>A.1 Full internal appraisal: "individual" / property-specific valuation produced following the full internal (!) physical inspection of a property (hence checking its condition) and based on the selection of appropriate comparables.</p> <p>A.2 Drive By: "individual" / property-specific valuation produced after only viewing the exterior of a property.</p> <p>A.3 Desktop: "individual" / property-specific valuation produced without visiting the property.</p> <p>A.4 Beacon valuation: non-property-specific valuation produced by applying the principle that large groups of properties of similar age, type or other, may be valued by valuing just one "beacon", e.g. the most frequently occurring type of dwelling within the group, and assuming it is representative of the value of every other property as well.</p> <p>B. AVM Valuations Valuations undertaken by an Automated Valuation Model (AVM), a system that provides an estimate of value of a specified property at a specified date, using mathematical modelling techniques in an automated manner</p> <p>B.1 Comparables-Based AVM: "individual" / property-specific valuation produced by a sophisticated model that selects a bespoke set of appropriate comparables for each individual property being valued, similar to "individual" appraisers' valuations (see above).</p> <p>B.2 Other models (e.g. hedonics): Generic statistical valuation produced using mathematical modelling techniques in an automated manner, but treating entire segments of properties in the same manner, e.g. applying generic localised area parameters, hence not (!) property-specific.</p> <p>C. Indexed valuations Valuations produced by a simple computation that applies a House Price Index to a previous property value in order to update it to a subsequent point in time.</p> <p>One of the central points of this overview at this stage is to emphasise that Comparables-Based AVMs provide "individual valuations" using sophisticated modelling techniques that select a bespoke set of appropriate comparables for each individual property being valued. This selection of bespoke comparables is the same approach as taken in appraiser valuations.</p> <p>All further clarifications and amendments proposed by the EAA in its response are based on the distinction between these valuation types and will be referred to at several places.</p>	In the views of the EAA, chapter 7 further clarifications on a number of collateral valuation methods for non-performing loans. These clarifications are in the draft guidance to offer greater clarity on -and gr valuation solutions and may th results regarding the valuation
2	7 - Coll	7.1.	85, footnote 51	Amendment	<p>Adding the following sentence at the end of footnote 51:</p> <p>"Institutions may use statistical methods to monitor the value of the immovable property and to identify immovable property that needs revaluation."</p>	<p>The draft guidance states explicitly in Regulation (EU) No 575/2013 that on the same page puts emphasis on "statistical methods" to be used at the valuation of immovable property and to identify immovable property that needs revaluation, and should therefore be included in the draft guidance.</p> <p>Comparables-Based AVMs – i.e. statistical methods – are not only for the valuation of performing and non-performing loans but also for the revaluation of immovable NPLs.</p>

3	7 - Coll	7.2.3.	87	Clarification	<p>The section "Indexed Valuations" defines "indexation or any other automated processes" as "indexed valuations". To define all "automated processes", thus including "statistical methods" (see ID2) and, in particular, Comparables-Based AVMs (see ID1), as "indexed valuations" and to subsume them under this category is not only technically and methodologically misleading, especially in terms of quality of the valuation results, but also semantically wrong. Therefore further clarification is needed.</p> <p>Differences between statistical methods, in particular AVMs The EAA understands that there is little awareness among stakeholders (including regulators, legislators, lenders and investors) of the technical as well as the quality differences between the different statistical valuation methods that can be deployed within an automated process. To clarify these differences and to emphasise the unique characteristics in terms of quality, transparency, objectivity, accuracy and reliability of valuations obtained from Comparables-Based AVMs is therefore one of the central aims of the EAA.</p> <p>Potential problems with pure Indexed valuations The EAA fully agrees with the ECB's recommendation in the draft guidance to exclude valuations for non-performing loans of more than 300,000 EUR in gross value, which are purely derived from using an index. In fact, the EAA would recommend excluding pure indexed valuations also for NPLs of less than 300,000 EUR. The reason is that there are indisputable and demonstrable disadvantages in a purely indexed valuation, which include: <ul style="list-style-type: none"> An index is merely an average house price development for a typically large regional area; as a result, discrete locations within this area can show vastly different house price developments compared to the average that the index suggests. An index requires a previous property value; as a result, any bias and inaccuracies included in this previous valuation, which in the worst case may even include fraudulent intent or excessive optimism that might have been present in the valuation at origination, will be forever carried forward in an indexed valuation An indexed valuation has no reliability indicator or Confidence Level and thus lacks a predictive measure expressing the estimated accuracy of each valuation. This is of particular importance when valuing unique or non-standard properties since these are much harder to value than standard properties and should potentially not be relied upon. <p>Due to the above, indexed valuations of immovable properties are prone to carrying a high degree of uncertainty, inaccuracy and bias.</p> <p>Advantages and technical differences of AVMs vis-à-vis pure indexed valuations <ul style="list-style-type: none"> An AVM does not require a previous property value as input and thus does not carry forward forever any bias, fraud or excessive optimism that might have been present in the original valuation An AVM is able to value properties where no previous transaction is known to the party requiring the valuation, thus making up for any missing, misguided or deliberately misleading data within the mortgage book An AVM is demonstrably more accurate and therefore more reliable than the traditional revaluation methodology through indices. This can be shown in a simple and scientific manner through extensive empirical tests, which are in fact regularly conducted by all EAA members on large property data samples from various European jurisdictions. Their detailed results can of course be obtained upon request. An AVM includes a Confidence Level as additional output with each valuation result, thus providing risk managers with an indication of accuracy at a property-by-property level and allowing them to achieve much greater granularity in their models than with any other approach. Unique or non-standard properties are harder to value than standard properties, which would typically result in a low Confidence Level, whereas they would raise no alerts when using indexation. This, however, is very important information for the user of the valuations, in terms of risk assessment and as an indication of how much reliance they can place on the valuations itself. Confidence Levels also form the basis of the Rating Agencies' published treatment of AVMs, resulting in much lower "haircuts" than those applied to indexed valuations. </p></p>	<p>The section "Indexed Valuation automated processes" as "indexed valuations" needs to be clarified and care taken between different types of "automated processes" and the different statistical methods" and the different statistical methods" and those based on other "statistical methods" (see ID2) reference to Comparables-Based AVMs (and other automated processes) and to subsume them under the category of "statistical methods" of the valuation results. On the basis of the reasons given in the guidance should be amended as to allow institutions and other stakeholders to use the tools at their disposal for the revaluation of collateral under</p>
4	7 - Coll	7.2.3.	87	Clarification	<p>The section "Individual Valuations" defines these as "property-specific appraisals which are performed by an appraiser on a specific property basis and are not based on indexation or any other automated process". This statement seems to use the term "individual" in a very unclear and misleading manner and needs further clarification for the following reasons.</p> <p>Property-specific appraisals take into account the characteristics of the property to be valued by selecting appropriate comparables. With indexation no such selection takes place. Instead indexation applies a simple calculation with pre-calculated parameters to all properties within a given group, e.g. in a given geographic area (a similar approach is taken also by hedonic models, where individual property characteristics are taken as an input but the calculation that produces the value is based on a set of pre-calculated parameters that are bound to fixed categories and geographic areas).</p> <p>There exist, however, other solutions that can perform valuations of properties on a strictly "individual", property-specific basis as set out in the draft guidelines a) without necessarily being deployed "by an appraiser", and b) in fact possibly being deployed within an "automated process" other than indexation, hedonics or other generic statistical method.</p> <p>This is the case for AVMs that incorporate a Comparables-Based approach, whereby a bespoke set of comparables is selected for each individual subject property being valued. Methodologically, this is in fact the same approach as taken by an appraiser, the only difference being that the selection of the relevant comparables is not based on human – and therefore potentially subjective – judgement, but on state-of-the-art Artificial Intelligence solutions.</p> <p>An "individual valuation" can therefore be made by an appraiser or, as an alternative in those jurisdictions where they are available, by using a Comparables-Based AVM. In addition, appraisers themselves may make use of Comparables-Based AVMs in those jurisdictions.</p>	<p>The EAA fully endorses the use of individual valuations wherever possible, typically more accurate and more reliable than the use of indexation or other automated processes. The EAA recognises that new, automated forms of AVMs that incorporate individual valuations whereby individual valuations are used should be allowed as an alternative to individual valuations in jurisdictions where Comparables-Based AVMs are available.</p>
5	7 - Coll	7.2.3.	87	Amendment	<p>On the basis of the reasons given under ID1 and ID4, section 7.2.3 should be amended in the following way:</p> <p>"Individual property valuations (including updated individual property valuations) are defined as property-specific valuations, which are performed on a specific property basis and are not based on indexation or any other process that applies the same treatment to large groups of properties. Individual property valuations should be performed in line with the requirements of this chapter."</p>	<p>As explained in ID4, Comparables-Based AVMs as described in the draft guidance therefore have the possibility to use individual valuations as an alternative to indexation where they are available.</p>
6	7 - Coll	7.2.3.	87	Amendment	<p>On the basis of the combined clarifications given under IDs 1, 2, 3 and 4, the paragraph on indexed valuations in section 2.3 should be amended in the following way:</p> <p>"Indexed valuations Valuations derived from Comparables-Based Automated Valuation Models constitute an individual property valuation, whereas valuations derived from indexation or hedonic models do not constitute a revaluation or an individual property valuation. However, they may be used in jurisdictions where no Comparables-Based Automated Valuation Model is available, to update the valuation for non-performing loans of less than 300,000 euro in gross value, which are secured by immovable property collateral provided that the collateral to be valued is susceptible to measurement by such methods."</p>	<p>For detailed reasons please see ID3, as well as the clarification in ID4. The suggested amendment will ensure that the use of indexation for the revaluation of collateral under 300,000 euro in gross value in jurisdictions where Comparables-Based AVMs are available.</p>
7	7 - Coll	7.2.3.	87	Deletion	<p>The absolute threshold of 300,000 EUR should be deleted, since this is an arbitrary number.</p>	<p>A threshold of 300,000 EUR is not applicable throughout all jurisdictions for the revaluation of collateral under 300,000 euro in gross value, as property collateral, may be considered to be average or</p>

Table "Valuation Types" for ID1

Valuation types	Individual Valuations		Non-property-specific Valuations
	Internal	Not internal	
Appraiser valuations	Full internal appraisals	Drive-bys and Desktops	Beacon valuations
AVMs	No	Comparables-Based AVMs	Other models, e.g. hedonics
Indexed valuations and other automated processes	No		Yes