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European Central Bank

Brussels, 10 November 2016

Dear Mr Issenmann,

Commentary on September 2016 Draft ECB Guidance to Banks on Non-performing Loans – Section 7 Collateral Valuation for Immovable Property

Pour mémoire, The European Group of Valuers' Associations unites 64 national valuers' associations from 34 countries representing 70.000 qualified valuers either self-employed or employed by specialist consultancies, private sector companies, government departments or financial institutions both local and international. It sets European Valuation Standards (EVS).

Following the own-initiative proposal for a Revised AQR Manual Section 5 "Collateral and Real Estate Valuation" that we sent you a year ago, we welcome this opportunity to write to you again to comment on the ECB's draft Guidance on non-performing loans, specifically the valuation provisions.

Two remarks, the first about valuation standards, the second concerning the use of indexed valuations or any other automated processes.

1. VALUATION STANDARDS

7.4.1 Valuation methodology – General approach

> "Immovable property collateral should be valued, adhering to European and international standards (52). National standards can also be accepted if they follow similar principles."
>
> "(52) These include the European Valuation Standards EVS-20092012 (Blue Book) and the Royal Institute of Chartered Surveyors (RICS) standards." (p.90)

In the footnote, "European Valuation Standards EVS-20092012 (Blue Book)" should be replaced by 'European Valuation Standards EVS 2016 (Blue Book)' but we have a more fundamental remark.

The ECB's Asset Quality Review Manual states:

> "Real estate should be valued in line with European Standards EVS-2012 (Blue Book) and other international standards such as the Royal Institute of Chartered Surveyors (RICS) guidelines – where a conflict is seen EVS2012 will apply (for the avoidance of doubt – this should be considered to apply throughout the document). For the avoidance of doubt a full e.g. RICS report is not required."
> *ECB AQR Phase 2 Manual March 2014 Section 5 Collateral and Real Estate Valuation 5.1 Summary of the Approach, 4th bullet*

We very much appreciate the application of European Valuation Standards for NPL purposes as this translates a consistent valuation approach of the ECB which was initiated by the AQR Manual in 2014. We further believe that TEGoVA's previous methodological input to the ECB – some of which seems to have been taken up in the NPL Guidance – merits special attention to EVS. Finally, we presume that continuity and coherence of ECB Guidance are an important objective.

1.1 Grounding of EVS in EU law

A prime purpose of EVS is to ensure that the standards reflect EU law and policy. Definitions of key valuation terms in the Standards copy the definitions in EU law whenever these exist. Three of the ten EVS Guidance Notes highlight and project EU law in valuation-key fields: Services Directive, Alternative Investment Fund Managers Directive, Energy Performance of Buildings Directive. EVS Part 3 is devoted to "European Union Legislation and Property Valuation" so as to ground qualified valuers in the knowledge of EU law that increasingly underpins the national rules that they must adhere to.

EVS also accompanies the rapid EU mutations in banking supervision. Mortgage Lending Value is a case in point: EVS 2016 continues to provide the authoritative guidance on the assessment of MLV and enhances it with detailed analysis and explanation of the key issues and approaches to be followed. Other systemically key elements are the guidance on Property Valuation for Securitisation Purposes and Property and Market Rating.

No other 'international' standards do this. They are either emanations of standards pertaining to a single country or they are designed for a global audience without any link to EU law.

1.2 Drafting of the standards by European valuation experts for use by European valuers

EVS is much more than an adaptation to EU law and policy. It is also grounded in the valuation experience of its 64 national associations from across Europe representing 70.000 qualified valuers. EVS is the product and synthesis of these valuation cultures, serving increasingly as a template for national valuation standards.

1.3 Continuity and coherence of ECB Guidance

Finally, we presume that continuity and coherence are important to the ECB in its setting of Guidance. Surely it is preferable that the national competent authorities or banks who are the subject of the ECB Guidance be able to look to a single set of European standards so as to ensure consistent and coherent outcomes, and that the AQR Manual Guidance not be contradicted by the NPL Guidance.

In this context, as regards the scope of chapter 7, we note that Articles 208 and 229 of Regulation (EU) N° 575/2013 shall apply. As Article 229 CRR refers to market value as well as to mortgage lending value, both valuation bases are supposed to apply. However, par. 7.4.1 of the draft guidance states that all property collateral should only be valued on the basis of market value. We see an inconsistency here and call for the inclusion of the mortgage lending value under par. 7.4.1. in line with the cross reference to Article 229 CRR.

We are also concerned about the exclusion of the discounted replacement cost method as in many EU member states, this approach is used for certain properties in specific circumstances and is even enshrined in national legal provisions. We therefore recommend that the draft guidance admit the application of the most appropriate valuation approach for the respective property type, taking into account the national or even regional market characteristics. This decision should be taken by the qualified valuer.

It is our understanding that the draft guidance on NPLs introduces some stricter rules compared to those stipulated by Articles 229 and 208 CRR. While there might be good reasons to draft stricter rules in this area, they should nevertheless be in line with the overall principles of Articles 208 and 229 CRR. Hence, we doubt that the implementation of an internal quality assurance process carried out by a risk management unit would be an appropriate tool to challenge valuations completed internally and externally. We are convinced that the review of valuation reports can only be conducted by qualified valuers who *possess the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process"*.

In the same line of thinking, we are not convinced about the added value produced by a back-testing requirement stipulated under par. 7.4.3 of the draft guidance. Indeed, we think that the verification of valuation assumptions being reasonable and grounded in observed experience is already fully addressed by the monitoring requirements of Article 209 CRR which are conducted under the control of qualified and independent valuers. In contrast, back-testing necessarily translates into a model based approach where the specific features of the subject (NPL qualified) properties are not taken into consideration.

The draft guidance on NPLs furthermore deviates from the 'CRR language' by requiring an 'update' of individual valuations under par. 7.3 (Frequency of Valuations). As the term 'update' is not used by Article 208 CRR, we advise either to explain what 'update' means or to align the guidance to the wording of Article 208 exclusively using the terms 'monitoring' or 'review'.

2. USE OF INDEXED VALUATIONS OR ANY OTHER AUTOMATED PROCESSES

It is our understanding that valuations derived from indexation or any other automated process also encompass automated valuation models (AVMs). We would like to emphasise that AV models must meet certain requirements if they are to generate property valuations which are both reliable in terms of content and are recognised by banking supervisory authorities.

First of all, it is essential in our view that valuations produced by AVMs be based on comprehensive databases with reliable price and rental data derived from actual sale prices. The databases must be continuously updated and evidence of sources must be supplied. It is most important that the search algorithms and the approaches followed in order to evaluate the data employ the latest techniques and are both comprehensively documented and also generally accepted.

Most notably, we are convinced that AVMs must be valuer-assisted in order to address potential model risks. This requirement shall also apply for monitoring purposes of collateral values. More precisely, it is the role of the valuer to screen the quality of the data base and to double-check the reliability of the inputs to the model. All main valuation parameters such as estimation of costs, land prices, construction cost, capitalisation rates, comparative prices and/or rents to be incorporated into the programme must be clearly documented with respect to their empirical provenance.

To conclude, we strongly recommend to require AVM values be submitted to a plausibility check by a qualified valuer, providing the option to validate values on a single property basis.

7.2.3 Individual versus indexed valuations

> "**Valuations derived from indexation or any other automated processes** are defined as indexed valuations and do not constitute a revaluation or an individual property valuation. However, they **may be used to update the valuation for non-performing loans of <u>less than 300,000 euro</u> 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.87)

It is not clear to valuation professionals in what way a € 300,000 threshold avoids risk in such a manner as to justify resort to the use of indexed valuations or Automated Valuation Models (AVMs) without any control by a qualified valuer. While the work of qualified valuers is heavily monitored for compliance with professional valuation standards so that users of their valuation reports are confident in estimated Market value, similarly confidence in AVM's results is obtained by regular tests of results, analysis of input data and benchmarks. Therefore whenever application of AVM results is considered, it should be followed by requirements of regular independent and transparent tests conducted by qualified valuers. If these techniques are to be employed we suggest that no more than two estimates over a maximum period of two years should be made without a primary or further independent valuation undertaken by a qualified Valuer.

We are at your disposal for any further explanation or information you may require, including explanation of the very primitive nature of AVMs and their findings.

Yours sincerely,

Krzysztof Grzesik REV
Chairman of the Board of Directors