Sectoral Paper on Operationalising the 'Property Value'

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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…"

The final text implementing the Basel III definition into the new Article 229(1) CRR is as follows, having been agreed and approved by the Council and European Parliament:

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

(a) the value is 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 value to be significantly above the value that would be sustainable over the life of the loan;

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

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

(e) *where the property is revalued, the property value does not exceed the average value measured for that property, or for a comparable property over the last six years for residential property 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 and the reference period shall include at least three data points.

For the purpose of calculating the average value, institutions may use the results of the monitoring of property values in accordance with Article 208(3). The property value may exceed that average value or the value at origination, as applicable, in the 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 revalued 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 valuation of immovable property shall take account of any prior claims on the property, unless a prior claim is taken into account in the calculation of the gross exposure amount pursuant to Article 124(6), point (c), or as reducing the amount of 55 % of the property value pursuant to Article 125(1) or Article 126(1), and reflect, where applicable, the results of the monitoring required under Article 208(3).'

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, collectively through the EMF's Valuation Committee[1] and others, have joined forces to determine a series of key components which can support the practical and proportionate operationalisation of this concept, in 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 229 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 value 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 '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 and based on a process of ongoing discussion amongst the mortgage industry and valuation profession co-signatories to this Paper, the following reflections represent the latest indications, as a market 'compass', for the operationalisation of a transparent and consistent approach across Europe, whilst necessarily recognising and accommodating inherent differences between national markets. In the meantime, the mortgage industry and valuation profession co-signatories to this Paper remain in continuous dialogue to monitor relevant evolutions and further shape the indications below accordingly.

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

[1] The EMF Valuation Committee specialises in issues relating to the valuation of property for lending purposes and brings together full members from the banking/mortgage sector, including internal valuers, as well as a number of observer members from the valuation profession, providing a unique platform for the exchange of information, expertise and best practice.

- 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 during the lifetime of the loan. This target is further underpinned by the regular monitoring, review and revaluation requirements in Articles 208 and 229 CRR. The adjusted market value approach described in this Paper is furthermore entirely aligned with the EBA's "Policy Advice on the Basel III Reforms: Credit Risk Standardised Approach and IRB Approach"[2], as well as recent indications from the ECB in its Supervision Newsletter dated 14 August 2024[3], in which it describes how data collected by banks on markets as part of their risk weighting process and to monitor property values should be used to determine whether the market value should be subject to a haircut.

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 profession co-signatories to this Paper are largely of the view that the main, underlying components for this adjustment could be determined as follows:

  - **What:** The adjustment mechanism applies to all market segments and related property types.
  - **How:** The adjustment is determined at an aggregate geographical, market segment and property type level based on relevant observable[4] market data, taking account of market structure, practice and volatility, to identify whether current market values are above long-term trends, thus providing evidence of the adjustment to market values which would be appropriate.
  - **Who:** The aggregate-level adjustment is determined by, for example, an independent entity within a financial institution, a well-established and independent authority or organisation or an independent valuer, or another appropriate well-established and independent body, with national market oversight and access to the relevant market data.

- In order to ensure appropriate risk sensitivity and to account for the differences between and within property segments at national level, the adjustment approach requires 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 aligned with the valuer independence requirements of Article 229 CRR. The adjustment will be processed by professional and independent entities/bodies/individuals, as referenced above under section 2, hence also complying with the independence requirements of this Article and in line with its prudential rationale.

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 are based on best practices and international valuation standards that could serve as the starting point for meeting the requirements of

[2] Policy Advice on Basel III reforms - Credit Risk.pdf (europa.eu)
[3] Commercial real estate valuations: insights from on-site inspections (europa.eu)
[4] Observable data is defined as information that is readily available to market participants about actual events or transactions that are used in determining the value for the asset or liability. IVS 104 "Data and Inputs", Article 10.03.

Article 229 CRR, e.g. mortgage lending value, then consideration could be given to their use as an alternative to the market value with adjustment.

Conclusion

- As the 1st of January 2025 CRR implementation deadline approaches, it has become apparent through a monitoring exercise undertaken by the co-signatories to this Paper that EU jurisdictions are engaged in implementing the ‘property value’ requirements of Article 229, according to the nature of their property markets, to the organisation of their valuation practice and to their legislative traditions.

- This Paper represents the state of the art of the reflections of its co-signatories, on the basis of which they have established a market think tank platform dedicated to the operationalisation of the ‘property value’ concept and to following market developments in terms of data availability, digitalisation and sustainability. With the aim of providing transparency in the context of promoting the Single Market, the overall objectives of this Platform are to monitor implementation of the ‘property value’ concept on an ongoing basis and foster a regular exchange of information amongst sectoral actors.
