European Mortgage Federation – European Covered Bond Council (EMF-ECBC)

Final Comments on Collateral Valuation & ESG Risks

19 March 2024

The European Mortgage Federation-European Covered Bond Council (EMF-ECBC) has read with interest the European Banking Authority's (EBA) October 2023 **Report on the role of environmental and social risks in the prudential framework of credit institutions and investment firms**.

Indeed, the Report, in assessesing how the current prudential framework captures environmental and social risks and in recommending targeted enhancements to accelerate their integration across Pillar 1, will likely be instrumental in shaping the European Commission's approach in this area to accelerating the transition towards a more sustainable economy, while safeguarding the banking sector's resilience.

The EBA proposes a series of recommendations for short and medium to long-term actions across a number of relevant areas for the EU's mortgage and covered bond industries and the EMF-ECBC is considering these closely. In the short term, the EMF-ECBC is particularly interested in the analysis of and recommendations related to collateral valuation:

The EBA makes two specific recommendations/commitments relating to collateral valuation:

1. *The EBA recommends that institutions account for relevant environmental factors in the **prudent valuation** of immovable property collateral. In particular, institutions should consider making necessary adjustments when the current market value of the collateral does not adequately address relevant risks associated with environmental factors that **could affect the sustainability of the market value of the property over the life of the exposure.** These considerations should include climate-related transition risk and physical risk, as well as other environmental risks, and should cover valuation at origination, re-valuation and monitoring, whenever relevant for current market values **<u>and</u> sustainable market values** over the life of the exposure.*

2. *The EBA will continue monitoring how environmental factors and broader ESG factors are reflected in the value of collateral, with due consideration of national specificities that may exacerbate environmental risks.*

The EMF-ECBC would like to offer some observations and potential clarifications in relation to the first recommendation in particular. In order to do so, it is important to clearly distinguish between 'market value' and 'prudent value' and the definition and purposes of each:

Market Value (& articulation of E & S risks)

1. The Capital Requirements Regulation (CRR) (Article 4(76)) defines 'market value' as: *'for the purposes of immovable property, the estimated amount for which the property should exchange **<u>on the date of valuation</u>***

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between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion'.

2. By definition, therefore, the independent valuer 'marks to market', meaning that the market value is a 'point in time' value. The market value **is not and can never be 'sustainable'** over the lifetime of a loan.

3. It is however the case that where the market is reflecting value and risk drivers linked to property characteristics related to **E & S factors**, the valuer's opinion of market value will also reflect these drivers on a reference date, to the extent of course that there is data, transparency and clear/consistent evidence in the market. The presence or absence of relevant property characteristics may be reflected by the independent valuer in the valuation as a driver of a higher value or taken account of via a discount. It is worth noting that the valuation profession and financial institutions are also seeking, individually and in cooperation, to deliver guidance, advice and tools aimed at further enhancing the articulation of environmental and climate-related factors in collateral valuation through a variety of different initiatives, including the Energy Efficient Mortgages Initiative[1], the RICS Leaders Forum ESG Data List[2] and the IVSC Perspectives Paper on ESG & Real Estate Valuation[3].

4. It is important to underline that a market value which takes account of E & S factors remains a 'point in time' value and does not become a 'sustainable' value or a value which is sustainable over the lifetime of a loan.

Prudent/ Property value

5. Separate from the concept of the market value, which as outlined will include E & S factors where these are reflected by the market, is the concept of a **'prudent value'** or **'prudent valuation'** specifically in the context of the calculation of credit risk over the lifetime of a loan. In the recent revision of the CRR, the European Commission implements the Basel Committee's 'prudent value' which requires the following: *'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'*[4]. This value is referred to in the revised CRR as the 'property value'.

6. The mortgage industry and valuation profession representatives recently joined forces to set out a series of key components[5] which will support the practical and proportionate **operationalisation of the 'property value'**, drawing on market best practice and expertise and in full alignment with the CRR and with the BCBS' original recommendations. At the heart of the joint approach is the **market value** which is the logical and proportionate basis for the determination of the 'property value'. Indeed, the market value remains a transparent, comprehensive, consistent and well-established valuation approach, which has been applied by the valuation and mortgage industries across Europe and beyond for decades.

7. From the market value and in 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 'prudent' and 'sustainable' value and contributes to the target of the property value not being higher than the market value.

[1] https://energyefficientmortgages.eu/wp-content/uploads/2021/07/EEM-Property-Valuation-Guidelines.pdf
[2] https://www.rics.org/news-insights/wbef/the-future-of-real-estate-valuations-the-impact-of-esg
[3] https://www.ivsc.org/esg-and-real-estate-valuation/
[4] https://www.bis.org/bcbs/publ/d424.pdf
[5] https://hypo.org/app/uploads/sites/2/2023/10/Final-Sector-Paper-on-Operationalising-the-Property-Value-20-October-2023.pdf

8. Article 208(3) of the CRR provides that the **property valuation should be reviewed** when information available to institutions indicates that the value of the property may have declined materially relative to general market prices. The revised CRR complements this provision with additional specifications highlighting the potential for certain ESG-related considerations to provide an indication that the value of the property may have declined materially relative to general market prices. This is however intended as an ongoing, regular **ex-post monitoring and, if necessary, review requirement of the 'property value' which could give rise to a revaluation**; it should not be interpreted as an ex-ante 'predictive' requirement.

9. It is worth highlighting that the CRR also foresees arrangements for situations where modifications to a property, including improvements of the energy performance or improvements to the resilience, protection and adaptation to physical risks, **unequivocally increase the property value**. In such cases, the valuation can be reviewed upwards and, if appropriate, beyond the average value ceiling linked to revaluation, as laid down in Article 229 CRR.

Conclusion

10. The **market value remains a fundamental cornerstone of collateral valuation** as a transparent, consistent and well-established valuation approach, which has been applied by the valuation and mortgage industries across Europe and beyond for decades. The market value allows valuers to detect market speculation by using market data and to contextualise the market value in the market cycle.

11. The introduction by the Basel Committee on Banking Supervision (BCBS) of the concept of a 'property value' which has since been transposed into the CRR, delivers the following 'sequence' in the collateral valuation process, which ensures robustness, transparency, as well as appropriate prudence and sustainability of values, therefore also responding to the recommendations made by the EBA:
    - The 'point in time' **market value** of the property is determined by the independent valuer, taking account of all relevant drivers of value, including ESG-related considerations.
    - This market value is then subject to an adjustment, as per the Basel requirements and enshrined in the CRR, to achieve a **'property value'** which is intended to be more prudent and sustainable over the life of the loan. It is important to note that this 'property value' should not be interpreted as necessitating any additional 'discount' linked to ESG considerations; rather it should be interpreted as an adjustment, where appropriate, based on relevant observable market data to identify whether current market values are above long-term trends.
    - In line with the monitoring, review and revaluation requirements of the CRR, the 'property value' may be subject to **downwards adjustments ex-post** via a revaluation, if ESG-related considerations (or indeed any other considerations) indicate that the property value may have declined materially relative to market prices at that time.
    - At the same time, where a climate or environmental-related modification to a property increases its value, this can be reflected in an **upward revision of the 'property value'** beyond the average value ceiling linked to revaluation, where appropriate and relevant.

12. The EMF-ECBC firmly believes that the distinctions and clarifications outlined above are fundamental in any discussion around collateral valuation and specifically in relation to ESG risks and collateral valuation and should be foremost in future discussions on this topic in relation to the prudential framework and in any other relevant regulatory or supervisory contexts.