rev
Journal of the Recognised European Valuer

TEGoVA
THE EUROPEAN GROUP OF VALUERS' ASSOCIATIONS

www.tegova.org
April 2015 / Issue No. 11

TEGoVA Delivers Guidance on Market Value under CRR at Berlin Summit

The Brandenburg Gate, Berlin

Article 4 paragraph 76 of Regulation (EU) No 575/2013 of The European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 sets out the following definition of market value:

"The estimated amount for which the property should exchange on the date of valuation 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 being under compulsion."

By virtue of the EU Regulation the above definition is legally applicable in every EU and EEA member state from 1st January 2014 when banks intend to use a preferential risk weight for their mortgage loans. In practice, banks normally go through a preferential risk weight because equity is scarce and therefore it is likely that most of the banks' mortgage books will be valued on the basis of the CRR definition. Valuers in Europe will know that the Capital Requirements Directive of 2006 included an almost identical definition of Market Value and a full interpretation is set out in European Valuation Standards 2012. Unfortunately the CRR itself does not include the accompanying interpretation. Thus in order to prevent a free for all in the interpretation of definition of market value under the Regulation, TEGoVA will be delivering special guidelines in this respect at its European Valuation Conference in Berlin on 17th April 2015.

To summarise, Market Value is measured as the most probable price reasonably obtainable in the market at the date of valuation in keeping with the Market Value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by any special terms or circumstances such as financing which are not typical, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any elements of Special Value.

Of particular importance, valuers should note that market value of a property reflects the full potential of that property so far as it is recognised by the market place. It may thus take account of the possible uses of the property that may be unlocked by changes affecting it, whether new development control permissions, relevant infrastructure, market developments or other possibilities. Thus the market value may reflect so called "Hope Value" which is an uplift in value which the market is willing to pay in the hope of a higher value use or development opportunity being achievable than is currently permitted under development control, existing infrastructure constraints or other limitations currently in place. However the valuer must not make unrealistic assumptions about market conditions or assume a level of Market Value above that which is reasonably obtainable.

The valuation amount will reflect the actual market state and circumstances at the effective valuation date, not at a past or future date. The definition also assumes simultaneous exchange and completion of the contract for sale without any variation in price that might otherwise be made in a market value transaction. Market Value is quite expressly not an assessment of value over the longer term but only at the time of the hypothetical transaction.

Also Market Value is independent of and uninfluenced by the objectives of the client instructing the valuation. It assumes *"an arm's length transaction"* between parties who do not have a particular or special relationship. ●

Mortgage Lending Value Position Paper Stirs Banking Industry

The release in January this year of TEGoVA's position paper on Mortgage Lending Value (MLV) methodology has enlivened debate within the valuation profession, the banking industry and national regulators across the EU. There is now the realisation that Mortgage Lending Value could become a serious contender against market value as a credible alternative "basis of value".

The Capital Requirements Regulation requires the European Banking Authority to develop draft regulatory technical standards to specify: *"the rigorous criteria for the assessment of the mortgage lending value …"* The latter is defined in Article 4(74) as follows:

"'mortgage lending value' means the value of immovable property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property;"

The concept of a long term sustainable value goes back to the German Mortgage Bank Act of 1900. The latter was replaced by the Pfandbrief Act 2005 and in 2006 the various rules for determining MLV were consolidated in a Regulation (Beleihungswertermittlungsverordnung, BelWertV). In the circumstances it is to be expected that any EU regulation in this matter will be heavily reliant on German practice developed over many years. Nevertheless TEGoVA counsels the need for a sufficiently flexible approach in order to allow European MLV rules to be adapted to the diversity of national mortgage finance systems and real

estate markets in EU member states.

The provisions of the CRR empowering the EBA to draft regulatory technical standards in relation to MLV methodology present a unique opportunity to elevate the concept from a mere analytical tool to a respected "basis of value" positioned alongside Market Value in the valuation hierarchy.

In this connection TEGoVA believes that any EU regulatory technical standard which seeks to prescribe the appropriate methodology should do so without losing sight of the definition of MLV and without widening that definition in the prescribed methodology. Thus the latter should not extend to laying down minimum or maximum valuation adjustments or inputs. These should be left at the discretion of the competent valuer.

This is because such valuation inputs and adjustments can only be properly and accurately derived by an experienced and properly trained valuer following an in depth analysis of the local market carried out by such a valuer. ●

ECB is to SSM as EBA is to ESR

Over the last year, real estate valuers cannot have failed to notice two new kids on the valuation block namely the **European Central Bank (ECB)** and the **European Banking Authority (EBA)**. First, the EBA came to prominence in connection with its role of ensuring the orderly transposition of the Mortgage Credit Directive in all EU member states and then last year all hell broke loose with the European Central Bank ordering the so called Asset Quality Review. More recently the EBA has come back into focus ahead of a much anticipated consultation on Mortgage Lending Value methodology under the Capital Requirements Regulation. However there is no shame in admitting ignorance of the difference between these two bodies which now have such a hold over the valuation profession. This short explanation may prove helpful.

The European Central Bank (ECB), headquartered in Frankfurt, is the central bank for the euro currency tasked with maintaining its purchasing power and thus price stability in the euro area (19 EU member states).

The ECB HQ in Frankfurt

The legal basis for the single monetary policy is the **Treaty on the Functioning of the European Union** and the **Statute of the European System of Central Banks and of the European Central Bank**. The Statute established both the ECB and the European System of Central Banks (ESCB) as from 1 June 1998. It should be noted that the ESCB comprises the ECB and the national central banks (NCBs) of all EU member states whether they have adopted the euro or not. On the other hand the Eurosystem comprises the ECB and the NCBs of those countries that have adopted the euro. The Eurosystem and the ESCB will co-exist as long as there are EU member states outside the euro area.

The ECB is associated with the **Single Supervisory Mechanism (SSM)** a new system of banking supervision for Europe comprising the ECB and the national supervisory authorities of the participating Eurozone countries. Its main aims are to ensure the safety, soundness and stability of the European banking system. SSM is one of the two pillars of the EU Banking Union, along with the Single Resolution Mechanism.

The ECB directly supervises the 130 significant banks of the participating member states. These banks hold almost 82% of banking assets in the euro area. Other "less significant" institutions continue to be supervised by their national supervisors, in close cooperation with the ECB which can at any time take over directly supervision.

Last year, ahead of taking over the supervision of banks in the Eurozone, under the EU Banking Union, the ECB oversaw a comprehensive assessment of the 130 significant banks in the Euro area. The assessment joined up an "Asset Quality Review" (AQR) and forward looking stress tests. The AQR examined whether assets were properly valued on banks' balance sheets as at 31 December 2013. More than 6,000 experts across the Single Supervisory Mechanism examined more than 800 individual portfolios and assessed the quality of the credits of 119,000 debtors of banks.

The "Asset Quality Review" was particularly relevant to valuers as the ECB AQR Manual's *"Collateral and Real Estate Valuation"* section provided *"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 EVS 2012 will apply …"*

The European Banking Authority (EBA) is a London based independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. It contributes, through the adoption of Binding Technical Standards (BTS) and Guidelines, to the creation of the **European Single Rulebook** in banking throughout the EU. The Single Rulebook includes the Capital Requirements Regulation (CRR), the Capital Requirements Directive (CRD IV) and the Bank Recovery and Resolution Directive (BRRD), the corresponding technical standards developed by the EBA and adopted by the European Commission (RTS and ITS), as well as the EBA Guidelines and related Questions and Answers.

The EBA is also mandated to assess risks and vulnerabilities in the EU banking sector through regular risk assessments and pan-European stress tests. The aim of such tests is to assess the resilience of financial institutions to adverse market developments, as well as to contribute to the overall assessment of systemic risk in the EU financial system.

In parallel with the ECB's "Comprehensive Review", at the end of last year, the EBA published the results of an EU-wide stress test in respect of a sample of 123 banks (Euro and non-Euro zone) covering up to 12,000 data points per bank across the entire EU.

Of most significance to the valuation profession is the EBA's obligation under the Capital Requirements Regulation to develop draft regulatory technical standards to specify: *"the rigorous criteria for the assessment of the mortgage lending value …"* Watch this Space! ●

A Message from the Chairman of TEGoVA

As the associations which make up "TEGoVA Deutschland" welcome delegates to the Spring Meeting of TEGoVA and a European Valuation Conference in Berlin this week, the release of guidance on the interpretation of market value under the Capital Requirements Regulation (see page 1) is very timely. In my travels across Europe during my first year as Chairman of TEGoVA, I have found that this is a subject which requires urgent attention. Despite one common definition of market value, interpretation differs from country to country often explained by the requirements of local law, custom or the wishes of local regulators. Such differences range from the assumption that market value

is no more than the existing use value of a property, to valuing a property in its "highest and best use" to the inclusion of so called "hope value".

The TEGoVA guidance notes make clear that Market Value is "... the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer" and *"... valuers should note that market value of a property reflects the full potential of that property so far as it is recognised by the market place. It may thus take account of the possible uses of the property that may be unlocked by changes affecting it, whether new development control permissions, relevant infrastructure, market developments or other possibilities."*

The definition of Market Value under the Capital Requirements Regulation is now law in each EU and EEA member state and for good reason. It is now up to TEGoVA to persuade valuers to interpret that definition in the same way in the interests of market transparency. ●

Krzysztof Grzesik REV

The ECB's Asset Quality Review and its Influence on Valuation Practice in Italy

By Silvia Cappelli, Vice President ASSOVIB, TEGoVA Board Member

Between February and October 2014, the European Central Bank and participating National Competent Authorities, responsible for banking supervision, carried out a comprehensive assessment of the 130 so called significant banks in the Euro area, in line with the provisions of the regulation on the single supervisory mechanism. One of the elements of the comprehensive assessment was the Asset Quality Review (AQR).

The top 15 Italian banks were thoroughly surveyed with particular focus on the quality of their real estate collateral. It should be noted that at the end of 2014, impaired loans in Italy amounted to over € 300 billion of which some € 200 billion was in respect of non-performing loans, half of them in real estate. The in-depth assessment of real estate collateral held by the major banking groups involved the collaboration of five independent external appraisal companies appointed by the Bank of Italy to:

- examine the adequacy of collateral covering credit exposures;
- realign the value of real estate collateral to current prices of the market;
- define a more homogeneous modus operandi – in terms of collateral valuation – among credit intermediaries.

Four out of the five external appraisers are all members of ASSOVIB (Italian Association of Valuation Companies), which represents the industry of the real estate valuation companies for banks in Italy.

The headline results of the Italian AQR were presented at a full-day conference last month in Milan promoted by the Politecnico di Milano and ASSOVIB. The conference was attended by an impressive 300 delegates.

In summary the total real estate collateral examined comprised about 8,000 properties (76% in Italy and 24% abroad) of which 55% were residential units, 10% industrial, 5% retail and 30% from other sectors.

The exercise identified a minus 10.05% gap between the assessments undertaken by the external appraisers and the value recorded by the audited banks. Some of this difference is due to a mismatch in the timing of the assessments undertaken by the banks and the external experts respectively. The remaining discrepancy was due to the different methodologies adopted. The AQR experience highlighted the importance of valuing according to recognised valuation standards and of the need to follow a transparent and regulated valuation process under enforced rigorous quality control in order to guarantee fair and accurate valuations.

The real estate valuation companies involved in the AQR, selected amongst a dozen firms by public tender, were able to react promptly, in an efficient and structured way, to the requirements of the European Central Bank and the Bank of Italy. The exercise has had a beneficial effect on the real estate valuation profession in Italy as the market expects that AQR was not a one off episode but, rather, one set to become the norm for auditing banks' assets in the future. This is likely to be spread throughout the entire banking system to include also medium and medium-small sized financial institutions.

Last May, a working group managed by the Italian Banking Association (ABI), responsible for updating the Italian Guidelines for property valuations, signed a declaration of compliance of the Italian Guidelines with EVS 2012, specifically in connection with the AQR process.

ASSOVIB will continue to co-operate with the Italian Banking Association in setting standards for property valuations for the banking industry and contributing to raising the quality of property valuations in Italy. ●

Energy Performance Certificates – Issues of Quality, Correlation with Market Value and Relevance to Valuers

By Michael MacBrien, Advisor to TEGoVA

"... if no measures are adopted to tackle the problem with the very poor quality energy performance certificates that are issued in some Member States only to fulfil the legal requirements, they may become a "useless administrative burden" set by Brussels and have even a negative impact on the perception for energy savings and for any future measures."

European Commission Impact Assessment for the recast of the Energy Performance of Buildings Directive, SEC(2008) 2864 of 13-XI-2008, p. 35, par. 4

Those words were prescient.

Twelve years after the first Energy Performance of Buildings Directive created the obligation for almost all buildings to have EPCs, six years after they began to appear on the market, this most visible component of EU energy efficiency law for buildings is in trouble. The problem? Though much of the heavy infrastructure is in place concerning requirements for experts, EPC methodology and tools, independent control systems and EPC registers and databases, the EPCs that are actually coming out of this great machinery are largely inadequate and often useless or misleading – in some countries despite relatively high costs – with devastating political consequences such as the Finnish Citizens' Initiative by which 62.000 people demanded that the EPC obligation simply be withdrawn for detached houses (taken up by the Finnish Parliament and raised with the Commission by the Housing Minister).

European Valuation Standards and Energy Performance Certificates
This has major fallout for the valuation profession and for TEGoVA. EVS 2012 contains an Application – EVA8 Property Valuation and Energy Efficiency – designed to guide the practicing valuer in correlating energy efficiency and Market Value and in assisting the client in obtaining maximum value from the EPC. Clearly, if the EPC is itself unreliable, that negatively impacts its usefulness to the valuer. Fortunately, EVA8 provides for this eventuality:

- **EVA 8.5.4.14** The valuer should advise the client where an EPC is not available or trustworthy and assess the situation for his report as seems appropriate in the circumstances and available knowledge.
- **EVA 8.5.4.15** The potential for buildings to have their energy efficiency upgraded by "retro- fitting" may be recognised in their market value. Equally, where that work would be more expensive, its potential cost may depress values. In such circumstances, ***the valuer may judge the significance and impact of the recommendations made by the EPC to improve the efficiency of the building.***
- **EVA 8.5.4.16** ***It will be for the valuer's professional judgment to determine whether and how anything more than the fact of the EPC is reported in the valuation.***

TEGoVA and its allies the European Historic Houses Association, European Landowners Organization, EPF and Union Internationale de la Propriété Immobilière are working with the European Commission to address the issue of EPC quality, but this issue is going to take years to resolve and in the meantime it may be necessary for EVS 2016 and TEGoVA education to provide greater guidance to valuers in recognising EPC deficiencies.

Identifying the Energy Efficiency Component of Market Value
Meanwhile, TEGoVA leads the European property industry in helping the European Commission avoid being confused by the numerous academic studies groping for correlation between EPCs and Market Value. A TEGoVA-drafted part of the common European property industry guidance to the Commission on the next phase of EU Energy Efficiency Policy for Buildings states:

"***For housing,*** even the study of some 325,000 transactions for dwellings in England, having controlled sale prices for many other variables, found that the four bands C, D, E and F, covering 98 per cent of the sample, had average sale prices within just a 2 per cent variance about B and D – B and C average prices being 2 per cent above B and D average prices and the averages for Bands E and F 2 per cent below Band D average prices. These are small variations, often appearing linked to related issues about the condition of the dwelling. There were stronger effects for the small numbers in the outlying bands B (5 per cent higher than Band D) and G (8 per cent lower) – with only 7 properties in Band A.

The information effect of EPCs (still an innovation in the market) appears small and improving their quality is key to seeing greater effects.

Even concerning commercial buildings, it is critical to distinguish between market practice on the one hand and any isolated emerging research that identifies a green alpha in a limited set of case studies. Such studies have typically been based on elective ratings (such as BREEAM and LEED) which tend to be deployed on buildings that are already part of the prime market and thus it is difficult to distinguish those features which contribute to a higher value.

There is an emerging scholarship which suggests that a more sustainable building may command intangible benefits such as improved productivity and health in the case of offices but a) such benefits are difficult to prove as reliable denominators are difficult to identify and b) it is largely thanks to the input of well-informed advisors that blue chip tenants are apprised of the potential benefits.

An emerging development in some markets is that well-informed tenants are typically asking for an impression of the total costs of occupation of a commercial building, and choosing buildings based on their operational cost element in addition to other traditionally dominant concerns such as rent and proximity to transport. Of course, the EPC does not assist in this regard, which is why there has been support for a dual actual/theoretical rating on the pan-European EPC that is in development by the Commission." ●

Inconsistent Yields and Cash Flows Lead to Lack of Market Transparency

By Marcin Malmon REV, Authorised Polish Valuer

One of the biggest barriers to transparency of the European real estate market is the adoption by valuers of a variety of yields in the valuation of investment properties by means of the income approach. Even within a single market such as Warsaw, valuers speak different languages, when it comes to defining yields. Anyone reading a selection of valuation or property market reports in relation to the Warsaw market at least, will not fail to notice reference to a variety of different types of yield, for example, initial yield, all risks yield, equivalent yield, equated yield, gross yield and net yield.

The key lies in understanding that when for example a prime property has been sold at a 7% "initial yield" this may perhaps actually translate into an 8% "equivalent yield" if the property was under-rented at the date of transaction or a 6% "equivalent yield" if "over-rented". Furthermore it is important to understand whether a quoted yield reflects costs of purchase or whether it is based on the contract price alone. The difference could be as much as 50 basis points. Confusion also arises because whereas "initial yield" is often used as the simplest yardstick of property valuation … which is current rent divided by the purchase price of the property, in some countries (including the UK) the latter includes purchase costs. And yet, for many years now all major valuation standards including European Valuation Standards have emphasised that Market Value excludes costs of sale or purchase.

But definition is only part of the problem, the other lies in deriving yields in markets where there may be few investment transactions. In such circumstances valuation truly becomes an art based on the valuer's perception of market sentiment and a consensus on yields becomes established. Unfortunately such consensus is rather weak because of the lack of consistency in the nature of the yields adopted by valuers and market researchers.

Furthermore, in order for an investor to make the right choice of investment property he needs to understand whether his valuer has discounted the income flow from the property on the basis of an "implicit" or "explicit" cash flow. This is fundamental and yet there is much confusion about these concepts.

In constructing an "implicit" cash flow the valuer avoids any subjective assumptions about potential future market driven changes to income from a property. The market's perception of future income growth and risks is reflected in the yield (equivalent) itself, similar to an "all risks yield" used in a simple traditional capitalisation approach.

On the other hand an "explicit" cash flow reflects forecasts of future market driven changes in rental income and operational costs. This is normally achieved by rental indexation during the cash flow period and discounting by the adoption of a so called "equated yield". Until there is some agreement within the valuation profession on the consistent adoption of yields and a harmonised approach to constructing discounted cash flows we cannot hope for true market transparency. At a time when European Valuation Standards are gaining traction across the continent is it not time for TEGoVA to seize the initiative? ●