AEV’S CONTRIBUTION TO EBA’S CONSULTATION

ON DRAFT GUIDELINES ON LOAN ORIGINATION AND MONITORING

October 2019

AEV | ASOCIACIÓN ESPAÑOLA DE ANÁLISIS DE VALOR
44th José Abascal St (4th floor)
28003 Madrid (Spain)
aev@asociacionaev.org

Contact person:
Ms. Paloma Arnaiz | Secretary General

PRELIMINARY CONSIDERATIONS

The Spanish Association of Value Analysis (*Asociación Española de Análisis de Valor* | AEV) welcomes the opportunity to respond to and comment on the European Banking Authority Consultation Document on "Guidelines on loan origination and monitoring".

As major representatives of the Real Estate Valuation Industry in Spain, we will be specially emphasizing some aspects which are directly related to the characteristics of real estate guarantees and to their valuation requirements, guided by the experienced acquired in Spain after the 2007-2008 financial and real estate crisis and the subsequent application of a new supervisory framework on banking accountancy (Bank of Spain’s Circular Letter 4/2017, very much inspired in the ECB’s Guidance on NPL).

We remain at EBA’s disposal for any further comment or clarification that may be needed.

CHAPTER 4. GOVERNANCE REQUIREMENTS FOR CREDIT GRANTING AND MONITORING

Question 3. What are the respondents’ views on whether the requirements set in the draft guidelines are future proof, in particular in relation to technology enabled innovation (Section 4.3.2) and environmental factors and green lending (Section 4.3.3)?

Paragraph 21. Responsibilities of the management body

In addition to the responsibilities cited at this point, and given the essential role that guarantees play in the banking business and the importance of their proper valuation, it would be advisable that the Management Body would also be responsible for the approval of the policies that define which guarantees are eligible and how their valuation should be carried out. This requirement is, indeed, established in the Spanish supervision regulations (Circular 4/2017 of the Bank of Spain), after the lessons learned from the Spanish experience in the real estate crisis, which is fully transferable to other countries and models, both in the EU itself and outside it.

Paragraph 35. Specifications to be included within the credit risk policies and procedures

In relation to what is indicated in letter f) about the acceptance of guarantees and the use of credit risk mitigation measures, and in line with what was expressed in the previous comment, we believe that a mention should be made of the need for risk procedures to include a general policy for the valuation of guarantees, along with the description and attribution of internal responsibilities that is usually linked to such policies.

CHAPTER 5. LOAN ORIGINATION PROCEDURES

> **Question 8.** What are the respondents' views on the requirements for assessment of borrower's creditworthiness (Section 5.2)?

Paragraph 103. Verification of the borrower's prospect to meet obligations

In relation to this point, we miss the mention of an essential criterion, which is the LTV policy, on which most loans with real estate collateral are supported. We believe that such policy should be established with prudence, and that it should require the disposal of a rigorous valuation, which takes into account relevant market factors (liquidity, stability, etc.) that may affect the guarantee. We believe that this aspect is essential, especially considering that changes in the personal situation of borrowers that weaken the initial risk analysis may become more and more frequent, making the stability of the guarantee even more important. It is not necessary to remember the great importance of these types of loans in the EU, which is why the CRR includes special dispositions for them, linked precisely to their LTV levels.

Paragraph 157. Assessment of creditworthiness of the borrower in Commercial Real Estate

The comment on this point follows the same line as the previous one. We believe that the importance of the guarantee and the flows it generates cannot be overrated, and that must be an essential criterion.

Paragraphs 164-170. Lending for real estate development

In relation to this chapter, and considering that, very often, the property under development will act itself as the loan guarantee, it would be advisable to mention the importance of adopting a very prudent LTV policy for this type of properties. In particular, it is essential that their valuation be carried out by an independent expert technician, capable of providing in-depth advice on the expectations of development and future value of the guarantee.

Likewise, it would be advisable to establish criteria related to the need to prudently link disbursements to the effective execution of the works, and that no unconsolidated expectations on land are taken into account for its valuation. In short, financial institutions are not usually (nor should they be) real estate experts, and it should not be forgotten that real estate development is a field of great complexity and risk.

CHAPTER 7. VALUATION OF IMMOVABLE AND MOVABLE PROPERTY

Question 11. What are the respondents' views on the requirements for valuation of immovable and movable property collateral (Section 7)?

Paragraph 191. Internal policies and procedures for valuation

We consider it necessary that, at this point, specific mention is made to certain aspects that should be contemplated by the risk policies and procedures of the entities in relation to the valuations at origination, as is done in point 7.2 when talking about the monitorization and revaluation of guarantees.

In particular, these policies should include at least the following issues:

- The criteria for selecting and contracting valuation providers, aimed at guaranteeing the independence of valuers and the quality of valuations. To this end, these criteria could include aspects such as availability of human and technical resources, experience and knowledge of the markets, and strength and quality of methodologies and databases.
- The criteria and methodologies for monitoring the valuations issued by these providers.
- The valuation methodologies and procedures that would be applicable depending on the type of property.
- The reference value (market value, mortgage lending value) that will serve as value of the guarantee, depending on whether certain criteria should or not be applied, such us, for example, prudence, sustainability of value or others.

Point 7.1.1. Immovable property collateral (Requirements for valuation at the point of origination)

In this chapter, we find that it would be appropriate to incorporate some specific criteria for the valuation of properties under development, due to their special characteristics regarding valuation complexity and credit risk.

Paragraph 195. Specification of the approaches to be used by the valuer

We do not find it appropriate to originate a loan without performing an internal inspection of the property that acts as a guarantee. Besides, and specifically in terms of revaluation, we believe that another condition should also be added to the characteristics that properties must have so that a "desktop" or "drive-by" valuation approach might be considered (similar design, specifications and characteristics than others already valued): that it can be presumed that, ever since their full valuation took place, these properties have not suffered significant alterations in their original characteristics, and that their estate of condition is similar, since these two aspects can have material impact on values, due to their connection with energy efficiency, among other issues.

Our opinion is that it is essential that, at the time of the origination of the loan, an internal inspection of all the properties takes place, since the information and characteristics that will be collected at this time will be those remaining in the databases for the entire life of the loan, and the ones which will be used for the subsequent revaluations of the properties. Having a thorough and precise knowledge of these characteristics would be essential, for example, in order to evaluate the adequacy of said guarantee for a green mortgage or to carry out subsequent control valuations throughout the life of the loan without the need to make a new internal inspection.

Paragraph 196. Significant deterioration in the repayment capacity

We consider that, when a significant deterioration of the borrower's payment capacity takes place, it would be advisable to carry out a new valuation of the real estate guarantee (as is, indeed, required by the supervisory regulations in Spain), given that a valuation includes important information about the estate of condition and actual value of the property, apart from its liquidity and enforceability. This valuation is essential to be able to value the credit itself.

Paragraphs 197 and 198. Requisites for external valuers

These two points are limited to the establishment of some criteria about the expertise needed of external valuers, and about the indemnity insurance that they must have. However, no similar or equivalent conditions are established for internal valuers, which we would consider absolutely necessary. Furthermore, in both cases criteria should be indicated to ensure independence of valuations, so that, in particular, the interests shared between internal valuers and their employer entities (which are logical in every employee) cannot affect the objectivity of the valuation.

Paragraph 199. Valuation independence

This paragraph indicates that valuations should be, preferably, requested or commissioned by the entity, condition which makes sense when it is assumed that any valuation provided by a borrower will be prepared at the request of a party or, in other words, not strictly objective. However, in several European jurisdictions, Spain among them, valuations for loan origination are requested and paid by borrowers to independent valuation companies or independent valuers. Therefore, and in order not to induce confusion in these cases, we consider that this statement should be formulated in a more generic way, for example, indicating that any secured loan requires an independent valuation of its guarantee, whatever its applicant may be, which will have to comply, in any case, with the quality criteria established by the entity.

Paragraph 200. Information to be included in the valuation

In relation to the information that must be included in the valuation, we suggest that also the sources of the data (surfaces, easements, charges) used to carry out the valuation be included, indicating, in particular, whether they come from public sources, from the valuer investigations or from third parties. Likewise, it might be appropriate for the valuations to introduce a critical judgment on the future sustainability of the certified value.

Paragraph 203. Requisites about external valuers

As indicated for paragraphs 197 and 198, we consider it necessary to establish equivalent requirements for internal valuers.

Paragraph 209. Accuracy of índices and statistical models

At this point, it should be noted that entities ought to consider the time elapsed since the last valuation of a property as a criterion to determine whether the application of index models is appropriate or not, since this type of methodologies lose reliability over long periods of time.

Paragraphs 211 and 212. Methods of revaluation

We believe that the wording of these two points is confusing, since it seems to imply that Article 208 (3) of the CRR could be interpreted as if the entities themselves could carry out the revaluation of their assets using AVM. Therefore, we consider that the text should be reformulated so that it is clear that the application of statistical methods is simply a specific methodology of valuation developed and executed by an external valuer. We believe that this is of material importance in relation to independence, since the interests of entities would not guarantee the objectivity of their reevaluations.

Paragraph 213. Valuation approaches

Same commentary as in Paragraph 195.

Paragraph 214. Rotation of valuers

Taking into account what has been indicated for points 211-212, we consider that it would be appropriate to point out in this paragraph that the rotation of valuers is also applicable when AVM models are used to carry out the revaluations.

Paragraph 215. Criteria for accepting advanced statistical model-based revaluations

In this case, we also consider that the text should clarify that the criteria for the acceptance of statistical models should be applied in the selection of the valuers who are suppliers of this type of valuations.

In addition, these criteria should include some that ensure the specific accuracy of the results that the entity will use once the valuation is received. We consider that the mention made of the need for backtesting is not enough, but that criteria related to the results of said backtesting must be incorporated.

Paragraph 223. Valuers' fees

We suggest that this point be complemented to indicate that the institutions should ensure that the valuation rates are consistent with the possible responsibility incurred by the valuer, in addition to being disconnected from the valuation result.

Paragraph 225. Requirements for valuers

Again, at this point we miss the establishment of criteria to avoid an alignment of interests between valuers (and, in particular, AVM providers) and the entities, in addition to those mentioned, which refer only to the independence between the valuer and the borrower. Indeed, the Spanish regulations in this field give us certainty that it is possible to identify specific elements that may constitute conflicts of interest for valuers in relation to the entities. For example, that the valuer is:

- Shareholder or creditor of the entity (or other companies in its group)
- Co-owner of assets (especially unlisted assets) owned by that entity or company.
- Beneficiary of a loan from that entity.
- Direct member or family member of any of the members of the board of directors or senior managers of that entity.

It would also be possible to define precisely in which cases such conflicts of interest can be material, that is, they can influence the valuer's judgment when carrying out a valuation:

- By economic criteria, identifying a precise threshold of the annual income of the valuer or his patrimony.
- By personal criteria: indicating specific cases (parents, children, siblings, partners in unlisted companies, etc).

Finally, we believe that it is perfectly possible to establish an external control of potential conflicts, either by forcing them to be communicated, by making them transparent in the valuation report so that the market itself exercises control, either by both paths.