Uploaded input to the EBA Consultation on draft Guidelines on loan origination and monitoring

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

26 September 2019

TEGoVA unites 71 valuers' associations from 37 countries representing 70.000 European valuers. It sets European Valuation Standards (EVS) and accords the Recognised European Valuer (REV) and TEGoVA Residential Valuer (TRV) qualifications. The Mortgage Credit Directive states that the reliable valuation standards that are to be put in place should take EVS into account *(Recital 26)* and the ECB's Asset Quality Review Manual gives EVS precedence over all other standards *(Section 5 Collateral and real estate valuation, final paragraph p. 145)*.

Part of the rationale of the Guidelines is to respect and protect the interests of consumers, and the Assessment of Options displays a sophisticated understanding of the nature and limitations of statistical methods / automated valuation models (AVMs). Yet the body of the guidelines falls short of the requisite ringfencing of desktop and drive-by (par. 195) and use of statistical models (par. 211):

PARAGRAPH 195

4. The objective of the guidelines is to improve institutions' practices and associated governance arrangements, processes and mechanisms in relation to credit granting in order *to ensure that institutions have robust and prudent approaches to credit risk taking, management and monitoring*, and newly originated loans are of high credit quality, *whilst respecting and protecting the interests of consumers*. Through achieving these objectives, the EBA aims at improving the financial stability and resilience of the EU financial system. *(Background and rationale, bottom p. 7)*

195. Institutions should set policies and procedures specifying the approaches to be used by the valuer (e.g. desktop, drive-by or full visit with internal and external assessment of the property) for different types of immovable property collateral ensuring that such approaches are prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements. For the valuation of an immovable property by a valuer, institutions may consider using desktop or drive-by valuation approaches only in the cases of valuing or revaluing immovable property collateral (e.g. RRE and CRE) that is of similar design, specifications and characteristics to the ones already valued or re-valued by a valuer, e.g. similar apartments in the same apartment block.

AISBL Groupe européen des associations d'experts immobiliers - TEGoVA -
Association n°: 26045/96   Company n°: 0459.529.481
Boulevard Saint-Michel 45   BE-1040 Bruxelles
Tel: +32 2 503 3232   Fax: +32 2 503 3234
Email: info@tegova.org   Web: www.tegova.org

"institutions may consider using desktop or drive-by valuation approaches only in the cases of *valuing*". This means desktop or drive-by *at origination*. The idea is that this is acceptable if the valuer has already valued a similar property. And yet:

1. There is reference only to similar design, specifications and characteristics. There is no reference to location! Micro-location characteristics may create significant differences (upward or downward) in value that desktop or drive-by valuations can't capture.

2. In some markets, conformity with planning regulations and building permits is of crucial importance. In some jurisdictions a property with illegal spaces is simply not transferable and is thus unsuitable for collateral purposes. A drive-by or desktop valuation can't detect such issues.

3. Similar is a vague term. Where does 'similarity' stop?

4. Who decides on the degree of similarity within the institution? A banker or a valuer? What happens in case of wrong decisions?

5. Valuation at origination is a different thing from revaluation, therefore different rules should apply and shouldn't be mixed in the same paragraph. The valuation at origination is the bank's only chance to gather data for the offered collateral and understand what is offered as loan security.

6. The delimitation of this concept ("*e.g.* similar apartments in the same apartment block") is so vague that banks will be free to interpret creatively.

7. Even the example of "similar apartments in the same apartment block" is flimsy in the extreme:

   - Different apartments in the same block can vary from derelict to recently renovated and although sometimes it is possible to know the date of the latest renovation, the quality and true extent of the works can't be verified without inspection.

   - Different apartments in the same block have different views, different access to light and different noise exposure.

   - Especially in certain member states, planning rules may not allow such-and-such internal structures, but it is still necessary to confirm de visu that the law has been respected.

It is important for bank regulators to understand just how crude 'drive-by valuation' is. It fully lives up to its name. Under no circumstances should desktop or drive-by be envisaged at origination.

The breach of the origination red line by these Guidelines works against the borrower's interest: It is valuation at origination which most closely concerns consumer protection. Borrowers need an accurate estimation of the value of this life-shaping transaction and indebtedness. For countries with stressed housing markets, the Commission's European Semester Country Reports highlight the consumer and prudential toxicity of underwater mortgages. This is why the Mortgage Credit Directive's Article 19

requires member states to have reliable valuation standards and in its Recital 26 sets European Valuation Standards as a template, *yet EVS under no circumstances allows drive-by at origination*.

In light of the above, we recommend:

195. Institutions should set policies and procedures specifying the approaches to be used by the valuer (e.g. desktop, drive-by or full visit with internal and external assessment of the property) for different types of immovable property collateral ensuring that such approaches are prudent and proportionate to the type and potential values of the collateral and in relation to the credit agreements. ~~For the valuation of an immovable property by a valuer, institutions may consider using desktop or drive-by valuation approaches only in the cases of valuing or revaluing immovable property collateral (e.g. RRE and CRE) that is of similar design, specifications and characteristics to the ones already valued or re-valued by a valuer, e.g. similar apartments in the same apartment block.~~

PARAGRAPH 211

... from a prudential point of view, the use of those models at the stage of loan origination may create shortcomings in the risk management. The use of advanced statistical models at the points of loan origination, i.e. at the stage of first assessment of the asset, might not ensure a reliable value attributed to the underlying assets and therefore a robust valuation process. Sometimes insufficient level of transparency, adequate governance in relation to these methodologies employed by the models might not ensure that valuation is based on well established and transparent market information coming from reliable sources. *(Valuation of immovable property collateral – Assessment of Options, p. 81)*

211. Where the conditions for a review in Article 208(3) of Regulation (EU) No 575/2013 are met, institutions should update the value of the immovable property collateral through a revaluation carried out by a valuer or through adequate advanced statistical models accounting for individual characteristics of the property, where such models are not used as sole means for the revaluation.

This text contradicts the prudent and balanced attitude toward statistical models in the Assessment of Options. Paragraph 211 seems to say that when CRR Art. 208(3) is in play, ergo, inter alia, where there's suspicion that value may have declined, it is acceptable to use *either* a valuer *or* statistical models ... "where such models are not used as sole means for the revaluation", it being explained on p. 82 that this means simply that the AVM report has been "checked" by a valuer.

An AVM crunches available data according to the coder's instructions. It has no contact with or understanding/experience of the property. "Advanced" statistical models "accounting for individual characteristics" remain extremely crude. A qualified valuer who does nothing more than 'check' the AVM report to see if it seems accurate but who himself never inspected the property nor has any special knowledge of it, brings very little quality and accuracy to the process.

The next edition of European Valuation Standards (2020) will contain a template residential valuation report that includes:

- key assumptions explained with reference to the comparables listed and appropriate comment reflecting the logic and reasoning for the adjustments provided

- justification of the criteria chosen for selection of comparables (market area, size, type, etc.)

- list of comparables chosen and justification of each selection

These elements are essential to a meaningful estimation of value, yet they cannot be grasped by statistical models. They are as essential to a revaluation as to a valuation at origination, fully justifying the rule in the last sentence of CRR Art. 208(3) that:

> "Institutions may use statistical methods to monitor the value of the property and to *identify* property that *needs* revaluation."

Ergo, they may not be used for the revaluation itself.

The current edition of European Valuation Standards dates from 2016. In 2017, TEGoVA approved and rendered operational a new European Valuation Standard 6 "Automated Valuation Models (AVMs) and a new European Valuation Guidance Note 11 "The Valuer's Use of Statistical Tools". The Standard states:

> "AVMs cannot be used to produce a valuation report that complies with EVS independently of a valuation process founded, inter alia, on inspection of the property by the valuer and the application of valuation judgment by the valuer. Where used, an AVM is never more than a tool contributing to the valuer's estimation of value, for which he remains responsible."

Mirroring CRR Art. 208(3), EVS 6 allows use of AVMs for any other purpose than as a valuer's tool only for monitoring and for identifying property that needs revaluation.

In light of the above, we recommend:

> **211. Where the conditions for a review in Article 208(3) of Regulation (EU) No 575/2013 are met, institutions should update the value of the immovable property collateral through a revaluation carried out by a valuer ~~or through adequate advanced statistical models accounting for individual characteristics of the property, where such models are not used as sole means for the revaluation.~~**

The capacity of 'advanced' statistical models to 'account for individual characteristics of the property' is far too primitive to enable this EBA Guidance step-change to automatised valuation for revaluations that underpin the solidity of the bank's real estate collateral. Technological developments properly understood do not justify this deviation from CRR.

All the more so due to the extraordinary opacity of European AVM manufacturers and banks. How are regulators to judge the inputs and outputs and degree of relevance of comparables, accuracy and 'adequacy' of banks' 'advanced statistical models'? In this context:

PARAGRAPHS 215 & 216

> **215. Institutions' internal policies and procedures should indicate criteria for accepting advanced statistical model-based revaluations. These policies and procedures should account for statistical models' market experience, property-specific variables considered, use of minimum available and accurate information, and models' statistical precision.**

This paragraph is indispensable. However, it should only be relevant for monitoring the value of the property and identifying property that needs revaluation.

In light of the above, we recommend:

> **215. Institutions' internal policies and procedures should indicate criteria for accepting advanced statistical model-based** ~~revaluations~~ *valuations for the purposes of monitoring the value of the property and identifying property that needs revaluation*. **These policies and procedures should account for statistical models' market experience, property-specific variables considered, use of minimum available and accurate information, and models' statistical precision.**

Our comments on paragraph 216 must be understood in the same spirit:

> **216. Institutions should ensure that the advanced statistical models used for the purposes of revaluation of immovable property collateral are:**
>
> **a. property-specific;**

It is essential that it be "property- *and location*-specific".

> **b. valid and accurate, and subject to robust back-testing;**

> **c. based on a sufficiently large and representative sample; and**

It should be: "**c. based on a sufficiently large number of samples (extracted from all relevant available sources on the market) and a selected representative sample***"*

Valuers should consider all available market data relevant to the property valued and the same should apply to advanced statistical models. If a bank develops its own advanced statistical model based on its own data extracted from its own mortgaged properties, this is a limited source of data and the "representative sample" will not be representative of the market.

> **d. based on up-to-date data of high quality.**

We further suggest:

e. based on information about property condition in real time

This is another reason why AVMs cannot stand alone for a revaluation as they do not have the capacity to grasp the property's condition in real time. A valuer can inspect the property's *current* general condition, internal alterations and extensions, layouts and extras, all of which have a huge bearing on overall value. Recent variations of these factors if serious enough could mean the property may not even be saleable.

In light of the above, we recommend:

216. Institutions should ensure that the advanced statistical models used for the purposes of ~~revaluation~~ *monitoring the value of the immovable property collateral or identifying immovable property collateral that needs revaluation* ~~of immovable property collateral~~ **are:**

a. property- *and location-***specific;**

b. valid and accurate, and subject to robust back-testing;

c. based on a sufficiently large *number of samples (extracted from all relevant available sources on the market) and a selected* **representative sample;** ~~and~~

d. based on up-to-date data of high quality*; and*

e. based on information about property condition in real time.

We are at EBA's disposal for any further information or explanation.

CONTACT

TEGoVA Secretariat – Michael MacBrien

info@tegova.org

Tel: +32 2 503 32 34

Cell: +32 478 22 54 53