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PROPERTY VALUATION AND CAPITAL ADEQUACY IN INTERNATIONAL BANKS

A Review of the Proposed New Basel Capital Accord

IVSC

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A REVIEW OF THE PROPOSED NEW BASEL CAPITAL ACCORD

The International Valuation Standards Committee (IVSC) established a 'Group of Experts' to review current guidance contained within the International Valuation Standards on valuation for loan purposes. On January 16 2001, the Basel Committee on Banking Supervision issued proposals for a New Basel Capital Accord and the Expert Group was also asked to develop the IVSC response to these proposals which, for the first time, contained detailed discussion on valuation standards and methodology.

The proposals for the new Basel Capital Accord are complex and lengthy, running to some 390 pages in all. However, they have important implications for many sectors of the real estate industry, not just for the valuation profession.

John Rich, who acted as IVSC technical consultant to the Expert Group, reviewed the proposals in full. He prepared an article, a digest noting areas within the proposals for possible comments, and greatly assisted the IVSC in drafting its response to the proposals.

The Board of the IVSC agreed that all three documents should be issued as one paper to assist IVSC member institutes in discussions on the proposals with national supervisory authorities and central banks, and to inform others in the real estate industry with an interest in the Basel proposals.

The article produced by John is his alone and does not necessarily represent the views of the IVSC Board. The IVSC Board would wish to publicly acknowledge its thanks to John for his work in developing the various documents that make up this paper.

The IVSC Board hopes that this paper is useful in helping others formulate their thoughts on the issues raised by the proposals for a New Basel Capital Accord and would welcome comments.

I certainly urge all IVSC member institutes to take this consultation seriously and to make representations through their national bodies.

Greg McNamara, LFAPI,A.I.Arb.A
Chairman, International Valuation Standards Committee

VALUATIONS AND CAPITAL ADEQUACY IN INTERNATIONAL BANKS

John Rich, MA

What do these two seemingly unconnected subjects have in common and what are the implications for the working practices of professional valuers and bankers? The answers to these two opening questions lie in the historic Swiss city of Basel (frequently anglicized as Basle), which lies on the banks to the River Rhine very close to the borders of France and Germany and thus close to the heart of Europe.

The Basel Committee on Banking Supervision (the Committee) issued a consultative document in January 2001 for a New Basel Capital Accord. In it, it states -
"In view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Committee holds the view that mortgages on commercial real estate do not, in principle, justify other than a 100% weighting on the loans secured." The obvious conclusion to draw from this is that banking supervisors do not think much of property as a loan security, unless it is the homes people live in. For a better understanding of the implications of this, some knowledge of "Basel" and the workings of its capital accord is necessary. Part I of this article gives a general and necessarily highly abridged overview to be followed in Part 2 by a more particular consideration of the aspects affecting, or affected by real estate valuations.

PART 1
"BASEL"

The Committee was established by the central bank governors of the Group of Ten countries in 1974 and today it consists of senior representatives of bank supervisory authorities and central banks from 13 countries[i] . Its permanent Secretariat is located at the Bank for International Settlements in Basel.

The Basel Committee does not have any formal international supervisory authority but generally seeks convergence toward common standards and approaches to supervision by formulating broad supervisory standards and guidelines to best practice. These serve as a benchmark for assessing the strength and stability of a country's financial sector. The ability of countries to actively participate in international markets increasingly depends on market perception of their conformance to international standards. The changes to the Basel Capital Accord are being proposed as much because sophisticated multinational banks have found so many ways to get round the old rules as the need for emerging economies to review their regulation of banks.

BASEL CAPITAL ACCORD 1988

The current Basel Capital Accord came into being in 1988[ii] but was subject to a few subsequent amendments.A deadline was set for full compliance by the end of 1992 with transitional arrangements in the interim to enable banks to build up their capital ratios and to allow phasing in of the Accord. Over 100 countries have adopted the 1988 Accord.

It sets out the details of an agreed framework for measuring capital adequacy and the minimum standard (of capital adequacy) to be achieved,mainly with regard to credit risk (i.e. the risk of counterparty, or borrower, failure). At its core lie two fundamental objectives, to strengthen the soundness and stability of the international banking system,

and to provide a fair and consistent regime across different countries with a view to reducing competitive inequality among international banks.In order to achieve this it is necessary first to establish a common definition and measurement of capital and then prescribe a measure for adequacy.

The 1988 Accord determines the key element of capital as equity capital and disclosed reserves and that this core element, referred to as Tier 1, should comprise at least 50% of a bank's capital base. The balance, subject to some fairly stringent rules for recognition, is termed Tier 2, or supplementary capital, which can include elements such as undisclosed reserves and revaluation reserves, depending on legal and accounting regimes in the countries concerned.

Banking supervisors the world over have generally agreed, through past experience, that prudent banks should only lend out a multiple of what the bank is worth,its capital, in order to safeguard depositors interests. However, not all lending carries the same degree of risk. It is deemed reasonable to reflect the different degree of risk by applying different risk weightings to different loan categories, hence arriving at the concept of risk weighted assets.The safest kind of loan is one in national currency to governments and central banks of stable economies and carries a risk weight of 0%.At the other end of the spectrum, commercial companies and most real estate loans carry a risk weight of 100%. Mortgages on residential property, occupied as a home, are allocated a 50% weighting.This kind of risk is termed credit risk and the loans, after weighting, are termed risk weighted assets (RWA).

Experience has taught that,in all but the most unusual circumstances, a bank should be able to meet its obligations to depositors if the ratio of capital to risk weighted assets remains at a minimum of 8%, the measure of "adequacy". Expressed another way, banks should not have aggregated risk weighted loans which exceed 12.5 times their capital. Of course it is not quite as simple as this,and if common standards and safeguards are to apply globally, then a whole raft of detailed regulation has to be set in place. This is what the Basel Committee on Banking Supervision attempts to achieve through its Capital Accords.

THE EUROPEAN UNION

Under Council Directive 89/647/EEC the EU introduced most of the measures contained in the 1988 Basel Accord with a date set for adoption into national laws by 1st January 1991 and full compliance by banks by 1st January 1993. There were, however, two striking differences which concerned loans secured on certain kinds of real estate. In order not to unsettle certain national financial markets credit institutions with holdings of mortgage bonds (known as pfandbriefe in Germany,) were allowed provisional dispensation to use a 10% risk weighting. By way of derogation from the 100% risk weighting, Austria, Denmark, Greece and Germany, were allowed to apply a 50% risk weighting,subject to conditions,to loans secured by mortgages on completed residential property, offices and multipurpose commercial premises in their own countries.

THE PROPOSED NEW BASEL CAPITAL ACCORD (BASEL 2)

Financial markets have seen huge changes in the decade or so since the Accord was introduced in 1988. The original Accord adopted a 'one-size fits all', rather simplistic approach which no longer reflects the way financial markets operate. At the same time, the leading banks have developed much more sophisticated risk management systems.This pace of development has culminated in the consultation for a New Basel Capital Accord issued in January 2001, seeking comments by 31st May 2001, with a view to implementation in 2004.

Basel 2 is an altogether longer and more complex document than the 1988 Accord. Together, it and its 6 explanatory supplements runs into 390 pages. The definition of capital remains unchanged and the minimum ratio of capital to RWA is still to be 8%.It describes a more closely targeted assessment of RWA within banks and provides incentives for doing so. Its fundamental objectives remain much the same as 1988 but with the additional aim of introducing a more comprehensive approach to addressing risk by examining the different characteristics of operational, credit, market and interest rate risk. The 1988 Accord uses a broad brush to allocate risk into bands, mainly relative to the status of the borrower, i.e. credit risk. Under Basel 2, whilst credit risk, after a more refined risk weighting procedure, may fall below the required capital ratio of 8%, nonetheless by the time operational, market and interest rate risk have been taken into account, the minimum remains 8%. Basel 2 uses three mutually reinforcing "pillars", minimum capital requirements, supervision and disclosure, to build the Accord, all three of which must be fully implemented. This therefore homes in on developments in the banking system and gives greater emphasis on banks own assessments of risks in determining capital requirements, reinforced by internal and external supervision, and enhanced disclosure. Although the new framework is primarily directed at internationally active banks, its underlying principles are intended, within time, to be suitable for all significant banks.

From a real estate perspective Pillar 1,capital adequacy with regard to credit risk, is the area of interest.Pillar 1 tries to apply some of the evolution in risk management and measurement to the weighting of different categories of assets.It proposes,at one level, a Standardised approach to credit risk with progression to a higher, Internal Ratings Based (IRB) approach, the latter itself progressing from a Foundation to an Advanced approach, with movement up the scale rewarded by an expected reduction in the total of RWA.

Under the Standardised approach borrowers are first categorised into groupings to which banks are at risk and then against each of those groupings risk weights are allocated according to credit assessments from external credit agencies.By way of example a sovereign government with a credit assessment of 1 or AAA would get a risk weighting of 0%, ie totally safe, whilst lending secured by mortgages on residential property might qualify for 50% weight and commercial real estate normally 100%. Recognition is given to credit risk mitigation techniques such as the use of collateral and guarantees. The Standardised approach also recognises an Exceptional Treatment, largely drawn from EU law for certain kinds of commercial real estate lending. This will be dealt with more fully in Part 2 of the paper.

The Internal Ratings Based Approach (IRBA), as its name implies, allows banks to use a measure of their own recorded experience in the weighting of risk.The Foundation stops short of permitting use of full internal credit risk models until such time as the depth of data is sufficient to validate model outputs at the Advanced level. The Committee hopes and expects increasing numbers of banks to migrate towards the IRBA, initially Foundation, but ultimately Advanced, as their internal data on risk measurement and management improves and intend that there should be an incentive to do so. Once a bank adopts the IRBA it must do so for all exposures across all significant business units. It cannot cherry pick and so mix IRB and Standardised approaches.

The IRBA sets out by catagorising exposures into six broad categories of asset according to the nature of the customer and the transaction; these are corporates, banks, sovereigns, retail, project finance and equity, each with different underlying credit risk characteristics.There is no specific category for loans secured on property but Corporates is used as a catch all for anything that does not specifically meet the definitions of other exposures.

The Foundation and Advanced methodologies presently apply only to corporate, bank and sovereign exposures, whilst a separate framework, still under development, applies to retail, project finance and equity exposures. For each exposure class, the treatment is based on three main elements: risk components, where a bank may use either its own or standardised supervisory estimates; a risk-weight function which converts the risk components into risk weights to be used by banks in calculating RWA; and a set of minimum requirements that a bank must meet to be eligible for IRB treatment.

The components of risk are identified as Probability of Default (PD), Loss Given Default (LGD), Exposure at Default (EAD), mitigants such as guarantees and credit derivatives and the maturity. Using the IRBA banks can apply their rating methodologies to assess the risk of borrower default and typically assign a borrower a rating grade which is then grouped. For each such grouping an estimate is made of the Probability of Default (PD).This PD estimate must represent a conservative view of a long run average. Many banks should be able to produce robust measures of PD but the Committee recognises that estimation of LGD does not have a similar track record of experience, set at a minimum of 5 years of historical observation. Therefore, in the Foundation approach LGDs are set according to supervisory rules at 50% for senior claims and 75% for subordinated ones but subject to the same mitigation techniques as the Standardised approach e.g. for guarantees or collateral. Loans secured by commercial property meeting the strict criteria for the exceptional treatment under the Standardised approach qualify for a dispensatory 40% LGD. Ultimately under the Advanced approach banks will be able to estimate their own LGDs, subject to certain minimum requirements.A series of formulae are then employed to derive a measure of Risk Weighted Asset (RWA) from the PD, LGD and sometimes maturity (M) figures. The total of RWA, used in determining the capital requirement may be further adjusted along the route to reflect granularity, i.e. the degree of single borrower concentration.

Retail exposures are seen as distinct from corporates,banks and sovereigns in that they are characterised as homogeneous portfolios comprising a large number of low value loans with either a consumer or business focus and where the incremental risk of a single exposure is small. Often Expected Loss is measured directly without analysis down to the components of PD and LGD. Portfolios of residential mortgages would appear to fall within this category.

EUROPEAN CAPITAL ADEQUACY RULES

The adoption of new European Capital Adequacy rules by 2004 is a key aim of the Financial Services Action Plan for a fully-integrated market in financial services by 2005. The Commission is working closely with the Basel Committee and has launched a contemporaneous consultation to the NBCA.The primary objective of the present Consultation Document is to reflect on the Basel capital review and to ensure that the revised framework takes appropriate account of issues that are of particular interest to the Union.There are two distinguishing features of the capital regime in the EU: first it is a legislative framework and second it applies to the entire banking industry and to investment firms irrespective of their size.

Conclusion

The aim of the banking supervisors has been to encourage banks to be far more analytical of the risks they take in lending. Those that have, over a long term, followed a cautious line in lending, such that they can prove a history of low recorded experience of default (Pillar 1), should be rewarded by having to maintain less capital against these loans. External supervisors will test and

check assumptions (Pillar 2) against common benchmarks, and the banks own records, to ensure safety, soundness and competitive equality within the banking system.Banks will have to disclose publicly more about their performance (Pillar 3). Beneath all this lie the lending practices and procedures attaching to individual loans, the successful, or otherwise, conclusion to term of which provide the statistics for risk profiling. With real estate as a very significant form of collateral for loans, valuations are a key element of a robust lending process. Part 2 of this paper looks at the implications of Basel 2 for real estate and valuations.

(i) Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

(ii) The 1988 Accord was based on a document entitled "International Convergence of Capital Measurement and capital Standards". Publications of the Basel Committee on Banking Supervision are available on the internet at www.bis.org

VALUATIONS AND CAPITAL ADEQUACY IN INTERNATIONAL BANKS

John Rich, MA

PART 2

Part 1 of this article outlined the main proposals for a New Basel Capital Accord (NBCA) and its implications for banks. Part 2 considers the consistency with which it deals with the real estate aspects.

CONSISTENCY BETWEEN DISCLOSURE FRAMEWORKS

In its December 2000 magazine, the International Monetary Fund (IMF) acknowledges that the 1988 Basel Accord has become the global standard by which the financial soundness of banks is assessed[i] . The NBCA proposes to refine those standards to a greater degree of sophistication. In developing its framework, the Basel Committee acknowledges, in several places, the part that can be played by external agencies in supporting the regulatory proposals. For example, under the Standardised approach Export Credit Agencies and external credit assessment institutions (ECAIs) are to play a key role in allocating risk weights. The Committee state that they will continue to work with accounting authorities, including the International Accounting Standards Committee (IASC), to promote consistency between disclosure frameworks[ii]. However, nowhere in the consultation documents is there any acknowledgement of the role of standard setting in the context of real estate valuation and its (self) regulation. This carries important consequences because, without such acknowledgement, the NBCA deprives itself of a whole raft of widely understood concepts of best practice and accepted definitions within the profession charged with the measurement of an important form of collateral, property.

Like the banking industry, the property valuation profession has been trying to improve its act and work towards globally agreed standards and definitions through the International Valuation Standards Committee (IVSC) and their recently updated IVS 2000. Like the Basel Committee, the IVSC is made up of representative members of national professional bodies, and, increasingly, the latter are adapting their own national standards to incorporate IVS. Recognition and dialogue by the Committee with the valuation profession would bring expertise on a particularly important risk mitigant, property.

MARKET VALUE

This is, however, about more than mere recognition, for there are areas in the consultation which will lead to considerable confusion and uncertainty both amongst banks and those they call upon to measure collateral. Perhaps the most striking point is the definition of Market Value itself. There is now a single definition widely accepted throughout the valuation world which is not only set out, but also given a very detailed description in IVS 2000.This is reproduced in many national standards. By embracing a term which is understood by the profession charged with its measurement Basel 2 would capture the entire supporting framework behind the definition. In practice what is currently proposed is a definition drawn from the European Union which was specifically coined to cover insurance legislation, and again was done so without proper consultation with valuers and in apparent disregard of a widely accepted existing definition.The difference in the definition may be minor and of little practical consequence but without the linkage to standards on implementation it undermines the efforts the valuation profession is striving to make to improve its performance. Further, it leaves the architect of the definition to support it with its own set of standards, or worse still unsupported at all by wider standards and codes.

Throughout the consultation there are other allusions to matters relating to property valuation which are casually drawn and again not linked to accepted practice or definitions amongst valuers. For example at paragraph 318 of the NBCA reference is made to objective market value, followed by a diluted description mixed with accountancy terminology.

Paragraph 38 of the NBCA (see Part I) passes a fairly damning indictment of commercial real estate as a collateral for lending. However, it is not solely down to the sometimes-volatile performance of property itself that has been the cause of troubled assets. Other factors, such as poor lending and valuation practices have contributed,and it is both of these that the development of banking and valuation standards tries to address. How much stronger they would both be if they worked together, and might not property show up in a better light as collateral a result?

EXCEPTIONAL TREATMENT FOR COMMERCIAL REAL ESTATE

The proposed NBCA admits an exceptional treatment for commercial real estate lending under the Standardised approach which is a departure from the 1988 Accord. This is loosely based upon the derogations permitted under European Union Law to seven states[iii] which had enacted Council Directive 89/647/EEC (as amended) into national law. To all accounts this was a hard fought and reluctantly conceded compromise during the preconsultation discussions because certain European countries have well established traditional financial markets which stood to be disadvantaged. For example, Germany has much at stake with its well established markets in mortgage backed securities and bonds (pfandbriefe) founded on a tradition of prudent lending practices with an enviable performance record evidenced by detailed statistics. The expression "loosely based" is used advisedly because there are material differences between the current European position and that proposed under Basel 2. Set out in the table below for comparison are the two relevant sections.

CURRENT EU POSITION	BASEL EXCEPTIONAL TREATMENT
Until 31 December 2006, the competent authorities of the Member States may authorise their credit institutions to apply a 50 % risk weighting to loans fully and completely secured to their satisfaction by mortgages on offices or on multi-purpose commercial premises situated within the territory of those Member States that allow the 50 % risk weighting, subject to the following conditions: (i) the 50 % risk weighting applies to the part of the loan that does not exceed a limit calculated according to either (a) or (b): (a) 50 % of the market value of the property in question. The market value of the property must be calculated by two independent valuers making independent assessments at the time the loan is made. The loan must be based on the lower of the two valuations. The property shall be revalued at least once a year by one valuer. For loans not exceeding ECU 1 million and 5 % of the own funds of the credit institution, the property shall be revalued at least every three years by one valuer; (b) 50 % of the market value of the property or 60 % of the mortgage lending value, whichever is lower, in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions. (ii) the 100 % risk weighting applies to the part of the loan that exceeds the limits set out in (i); (iii) the property must be either used or let by the owner.	The Committee, however, recognises that, in exceptional circumstances for well-developed and long-established markets, mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises may have the potential to receive a preferential risk weight of 50 percent for the tranche of the loan that does not exceed the lower of 50 percent of the market value or 60 percent of the mortgage lending value of the property securing the loan.Any exposure beyond these limits will receive a 100% risk weight.This exceptional treatment will be subject to very strict conditions. In particular, two tests must be fulfilled, namely that (i) losses stemming from commercial real estate lending up to the lower of 50 percent of the market value or 60 percent of loan-to-value (LTV) based on mortgage-lending-value (MLV) must not exceed 0.3 percent of the outstanding loans in any given year; and that (ii) overall losses stemming from commercial real estate lending must not exceed 0.5 percent of the outstanding loans in any given year. This is, if either of these tests is not satisfied in a given year, the eligibility to use this treatment will cease and the original eligibility criteria would need to be satisfied again before it could be applied in the future. Countries applying such a treatment must publicly disclose that these and other additional conditions. *Note:There appears to be an imprecision of expression in the reference to "..60 percent of loan-to-value (LTV) based on mortgage-lending-value (MLV)."*

The proposed NBCA omits alternative a) permitted in the EU, which effectively confines the exceptional treatment to those countries which already have established mortgage based financial instruments and a long history of statistical data proving low rates of default. Specifically, the exceptional treatment requires that "the supervisor of the country implementing this preferential treatment must provide loss experience information on the banking industry which would cover at least one economic cycle (that would include a downturn in commercial real estate prices) and span a minimum of ten years". Further, countries adopting it must "have the legal and supervisory frameword to provide this concept of MLV and its prudent mechanisms". Once again,there is no tying in of any of the definitions to established standards. However, Mortgage Lending Value (MLV) is a technique with a long tradition in certain European countries and has recently been incorporated into European Valuation Standards 2000 together with detailed background material as to its usage. It is described here deliberately as a technique since it is aimed at risk mitigation, and its validity depends on the user having detailed empirical evidence of market movement over a long period in inherently stable markets. These conditions can seldom be fulfilled elsewhere in the world and so it is not recognised presently as a method of valuation outside a tight circle in Europe. Since the wording under Basel states quite clearly a "lower of" option rather than "either, or" as under European rules the exception is effectively restricted to a few European states, which is probably what was intended. Effectively the Exceptional Treatment also extends into the foundation IRBA through a footnote which allocates a favourable LGD of 40% to commercial real estate collateral meeting the exacting criteria set out under the Standardised approach.The additional option a) under the EU Directive, whilst seemingly opening up the possibilities to a wider circle of countries has its own drawback insofar as it requires the employment of 2 independent valuers and directs that the lower value should apply. In a competitive world this is both expensive and largely impractical and so it is questionable whether a mere restoration of this paragraph to the Basel 2 paragraph would mollify critics.

The exceptional treatment is itself inconsistent with the remainder of the consultation documents insofar as it indulges in an unusual depth of detailed methodology of a discipline, property valuation,completely divorced from normal banking routines, yet it still pays no cognizance to any of the valuation industry's standards. It was unquestionably a compromise and it was entrusted to a working group of representatives from the USA, Japan and Germany to propose a way forward through some stridently held positions. Opinions are divided as to whether the Exceptional treatment will wither and fade as banks migrate to the Advance IRB approach, or alternatively, that more will be drawn towards the Exceptional treatment thus entrenching the Standardised and Foundation IRB approaches and perhaps a wider adoption of Mortgage Lending Value. The resultant paper has not enjoyed the same attention to detail and language as the main documents. The working language of the Committee is English and generally the NBCA and supporting documents are grammatically near perfect,whilst this cannot be said of the Exceptional treatment document. Whilst its general intentions are clear the expression is imprecise and conceptual so there is considerable scope for misunderstanding when it comes to be translated from imperfect English into other languages.

COMMERCIAL REAL ESTATE

Commercial real estate (CRE) is referred to repeatedly in the consultation documents not least in the context of the introductory comment in Part I referring to the poor historic lending experience. Confusingly, only one attempt to define CRE is made in the NBCA document itself and that is at paragraph 313 in the context of corporate loans. This effectively refers purely to what might be better described as operational property. It reads "collateral where the risk of the borrower is not materially dependent upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources. As such, repayment of the facility is not materially dependent on any cash flow generated by the underlying CRE serving as collateral;". It thus specifically excludes let CRE. Valuers could probably agree that CRE as defined is the least reliable collateral, the hardest to value accurately, and the most volatile, suffering most when economic circumstances increase the possibilities of default. Conversely, under the Exceptional treatment CRE lending is given a definition which specifically limits it to what might effectively be described as investment grade let property. Those with a vested interest in matters property might question whether the Committee has got this quite the right way round given the huge sums of money leant by banks secured on CRE. Statistics are difficult to come by, which perhaps explains the success of the European countries that do keep such data in arguing for the Exceptional Treatment. However, the European Central Bank stated[iv] that " property is the basic form of collateral accepted by banks and real estate lending constitutes the bulk of lending by banks and other credit institutions (62% of total lending to households and 32% of total lending in the Euro area at end June 1999". Recently released research in the UK put the total outstanding bank debt secured on property at £80 billion[v] although there is no breakdown given between the types of property security. Given that property is such a significant form of collateral it perhaps strikes one as odd that the most reliable and secure form of it should be relegated to an exceptional treatment whilst the least reliable is taken as the benchmark.

Conclusion

The whole tenor of Basel 2 is towards a progression to the Advanced IRBA where banks would measure and monitor their own statistical performance, watched by their supervisors, and published to the wider world. Little of this is prescriptive, allowing the records to speak for themselves.It would seem entirely compatible with this approach to embrace standards which support the process without being prescriptive of the minutiae of methodology. Mortgage Lending Value (MLV) as a valuation methodology is an emotive issue among valuers, with professionals in some countries praising its characteristics of prudence and longevity. Those who question the whole concept of a "fundamental value" and regard the methodology as wholly subjective match them with an equal passion. Given the concept of internal ratings and the statistical measurement of experience over long periods one wonders if Basel 2 is wise to stray into this territory of methodology at all. Even under the Standardised and Foundation IRBA the ancillary rules about long term record keeping are probably sufficient to inhibit more widespread application of reduced risk weightings amongst those banks and in those countries where it would be inappropriate. If a satisfactory track record for loans secured by CRE can be proved relative to enunciated prudent lending rules, then surely valuation methods are best left to the valuer. Property valuers have made great progress in introducing and extending standards globally and the New Basel Capital Accord could itself be strengthened by acknowledging this as part of their framework.

17 April,2001

(i) Finance and Development, December 2000, Volume 37, No 4. Toward a New Global Banking Standard:The Basel Committee's Proposals. Cem Karacadag and Michael W. Taylor

(ii) Overview of the New Basel Capital Accord. Page 35 para 207.

(iii) Austria, Denmark, Greece, Germany, Luxembourg, Italy and Portugal.

(iv) ECB Press release 3 April 2000 for paper "Asset Prices and Banking Stability".

(v) DTZ Research Estates Gazette 17 February 2001.

THE NEW BASEL CAPITAL ACCORD

The Basel Committee have issued 7 documents running to 390 pages detailing and supporting The New Basel Capital Accord.This paper notes in the tables following areas where it may be relevant for those involved in the valuation of real estate to comment.. It is acknowledged that the list of references may not be exhaustive. It is hoped that this digest will assist others in collating their thoughts in preparation for a response to the consultation and also that if readers have identified other areas, not mentioned here, then they will add to the tables and communicate this to IVSC. The aim is to assemble as near as possible a complete appreciation of the documents, from a property perspective, as possible. Not all references warrant a response, they are frequently identified merely to underline the argument for valuation standards.

There is a table of Acronyms (page 12) since these are not always familiar and are used repeatedly.

The consultative documents involved are as follows:-

John Rich
25 April, 2001

ACRONYMS

ABS	Asset backed securities
ABCP	Asset backed commercial papeer
CCF	Credit conversion factor
CRE	Corporate real estate
DM	Default mode
EAD	Exposure at default
ECA	Export Credit Agencies
EL	Expected Loss
ECAI	External Credit Assessment Institution
IRB(A)	Internal ratings based (approach)
IRR	Interest rate risk
LGD	Loss given default
LTV	Loan to value
MDB	Multilateral development bank
MLV	Mortgage lending value
MTM	Mark to market
PD	Probability of default
PDF	Probability density function
PSE	Public sector entities
PFE	Potential future exposure
RRE	Residential real estate
RWA	Risk weighted assets

Executive Summary

Reference	Subject	Comment
Paragraph 21 page 4	Responses to consultative Document.	The response should be to the national supervisory authority as well as to Basel Committee.

4. Description of the Framework

Paragraph 34 page 7	Other professional standards and regulations	Internationally accepted property valuation standards should also be recognised in this area.
Paragraph 43 page 9	The effect of cycles.	Need for stress testing on robustness of collateral
Paragraphs 93-94 page 17	Wider use of IRBA.	The Committee expects a wider use of IRB.
Paragraph 103 page 18	Supervisor set LGD. Subject to credit risk mitigation frame work of Standardised approach. Limited forms of commercial and residential real estate recognised as collateral.	This is an important para. Cross references to para 197 in NBCA reintroduces rules under Standardised approach.
Paragraph 207 page 35	Market discipline under . Pillar 3	Recognition of the benefits of liason with IASC to "promote consistency between disclosure frameworks.

PART 2: THE FIRST PILLAR - MINIMUM CAPITAL REQUIREMENTS

II. Credit Risk - The Standardised Approach

Reference	Subject	Comment
Paragraph 38 page 11	Commercial Real Estate to be allocated 100% risk weighting	Records that banks have had poor experience over the past few decades and in numerous countries from loans on commercial real estate.
As above – Footnote 14	Introduces Exceptional	1.The wording in the latter part of the note appears defective. " ...or 60% of loan-to-value (LTV) based on Mortgage Lending Value (MLV)...". Further, the wording is inconsistent insofar as para 2 of Supplement – "Criteria in defining exceptional treatment....." includes the word "ratio". Is not what is intended "...60% of Mortgage Lending Value.." as appears in the first sentence of the footnote? Surely the LTV is represented by the %, either 50 or 60, of either Market Value or MLV respectively. 2. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA does define. Some argue that it is incapable of objective measurement. 3. This wording seems to be derived from EC Directive 98/32 but omits para (a) of that document. Further, the exception here refers to "multi tenanted" which was not in EC 98/32

III: Credit Risk – the internal ratings based approach.

General comment. It is not entirely clear into which category commercial property lending would generally fall. It would appear to meet most closely the criteria for Corporate, and in some instances Project Finance exposures. Residential lending would appear to fall safely into the Retail category.

The foundation approach

Reference	Subject	Comment
Paragraph 152 page 32	Categorisation of exposure	As a catch all this places anything which does not qualify under other definitions into Corporates. Footnote 30 to para 207 (see below) confirms this.
Paragraph 197 page 40	Eligible collateral.	Specified Commercial and Residential Real Estate are recognised as eligible physical collateral.
Paragraph 198 page 41	Eligible collateral.	The criteria for eligibility are thrown forward to paras 310 to 321
Paragraphs 207-212 page 42	Commercial and Residential Real Estate as collateral for loans	This would seem to recognise that CRE and RRE can be regarded as collateral in measuring LGD under the section heading of Corporate Exposures
As above – Footnote 30	Capital relief available where physical collateral taken, subject to conditions. Recognition of exceptional circumstances and reference back to the Standardised approach in para 38 and to footnote 14	This would appear to recognise that either 50% of MarketValue or 60% of MLV is the appropriate measure of the collateral. If it meets the minimum requirements then it qualifies for a 40% LGD (as opposed to 50% normal)
Paragraph 210 page 42		In order to qualify for the 40% LGD (as opposed to 50% normal) there is a further requirement that the ratio between collateral value to the nominal exposure exceeds a higher threshold. Nominal exposure presumably means estimated sale proceeds plus all the associated costs in realisation.

THE ADVANCED APPROACH

General comment.This seems to be about sophisticated banks with well established internal monitoring systems and controls identifying their own internal risk exposures,measuring them and monitoring them over time. The Accord imposes some basic rules for regulators but generally avoids being unduly prescriptive in terms of methodology.

Reference	Subject	Comment
Paragraphs 312-315 page 57	Commercial and Residential Real Estate as collateral for corporate loans.	This seems to specifically exclude properties let as investments from being regarded as collateral for corporate loans This section is held out as providing a definition of commercial real estate, which it is not. It is describing the particular circumstances of corporate loans collateralised by real estate owned and usually occupied by the borrower.
Paragraph 318 page 58	Objective Market Value of Collateral	This paragraph would appear to introduce a number of concepts without linking them to any other standard. Fair Value is an accounting term defined by IASC and other standards. "...at or less..." would give legitimacy to any conservative valuation method including MLV however the rest of the definition seems to embrace much of the Market Value definition under IVSC.There must be scope to tie this paragraph to other professional measurement standards.
Paragraph 321 page 58	Additional collateral management requirements in order to meet operational needs.	Whilst this section is about managing collateral it does identify the need to be able to "establish objectively a price or market value....."

Reference	Subject	Comment
Paragraphs 332 to 345 pages 60 to62	Estimation of LGD	These paragraphs focus on measuring and monitoring LGD.With collateral as a significant element of this argument,the measurement of the collateral itself, specifically real estate should be fundamental to an accurate assessment. The application of valuation standards would help secure this.Whereas actual loses will be identified in historic records, the proportion they comprise of the whole book can only be measured against the estimated LGD of the non failing balance and the measurement of the value of the physical collateral is the work of valuers.
Paragraph 448 page 77 loan exposures	Segmentation of Retail .	This would seem to specifically recognise that secured lending is regarded as (or can be) retail.

Part 4: The Third Pillar - Market Discipline

Paragraph 655 page 123	Qualitative disclosures.	This provides another area where one could commend the ideas of standards for the measurement of collateral.

A Risk weights in the Standardised Approach

Reference	Subject	Comment
Paragraph 41 page 8	Risk weights for . retail assets	Allocates a 50% (favourable) risk rate to residential mortgages.
Paragraph 42 page 9 Footnote 8	Risk weights of claims secured on commercial real estate	1.Allocates a 100% (standard) risk weight to commercial real estate lending but recognises the Exceptional Treatment.Footnote 8 is a restatement ofFootnote 14 to paragraph 38of the New Basel Capital Accord. 2.The wording in the latter part of the note appears defective. " ...or 60% of loan-to-value (LTV) based on Mortgage Lending Value (MLV)...". Further, the wording is inconsistent insofar as para 2 of Supplement – "Criteria in defining exceptional treatment....." includes the word "ratio". Is not what is intended "...60% of Mortgage Lending Value.." as appears in the first sentence of the footnote. Surely the LTV is represented by the %,either 50 or 60, of either Market Value or MLV respectively. 3. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA does define. Some argue that it is incapable of objective measurement.
Paragraphs 53 to 62 page 11	Recognition of External Credit Assessment Institutions.	Ideally IVSC would seek similar recognition, representing as it does, the principles of objectivity, independence, disclosure and credibility when applied to standards for real estate valuations.

B. Credit Risk Mitigation in the Standardised Approach

Reference	Subject	Comment
Paragraph 100 page 18	Valuation of collateral	This paragraph is somewhat general so does not meet the comment above.
Paragraph 105 Page 19	Benchmarking	Perhaps somewhat tenuous, but there are now benchmarks for real estate performance which arebased on valuations and also indices.
Paragraph 110 Page 19	Eligible collateral	1. " Essential that collateral can be revalued reliably".This is the essence of valuation standards. 2. "...and that its value is relatively stable over time." T his could be said to be an argument in favour of MLV.
Pararaphs 111 to 114 page 20	Eligible collateral.	By ommission it would appear that real property is not generally regarded as eligible collateral.Whilst the Committee appears to recognise that real estate collateral,in certain exceptional circumstances, warrants a reduction in risk weighting, it does not appear to afford similar recognition when it comes to collateral. All the subsequent discussion of "haircuts" would appear to be on the basis that CRE and RRE are not involved.

Chapter 2: IRB Framework for Corporate Exposures

Reference	Subject	Comment
Paragraph 35 page 9	Definition of Corporate Exposures	Would appear to specifically exclude loans secured on investment property.
Paragraph 58 Page 13	Credit risk mitigation and rules for recognition of collateral	This recognises that for banks using the foundation approach, it draws heavily on the rules for recognition of collateral as outlined in the Standardised approach. Since the latter is dealt with by footnote 14 to para 38 this gives recognition to MLV. It also states that "nor is a specific technique for recognition (of collateral) set out.
Paragraphs 91 - 98 pages 20 & 21	Eligible commercial and residential real estate under the foundation approach (of the internal ratings based approach).	By referring this section back to the New Basel Capital Accord this links this section of the foundation approach of IRB back to the eligible criteria under footnote 14 of para 38. Reference to the amount of collateral in para 93 implies valuations. Para 94 seems to mirror the terms for Corporate Exposures but does not appear to be explicit on that point: See para 209 of NBCA, of which this para is a repeat, which is specifically under Rules for Corporate exposures. *Para 96 makes no reference as to how the collateral value is to be measured in determining the LTV ratio.*

Reference	Subject	Comment
Paragraph 96 page 21	Other forms of collateral.	Given that valuers value property other than pure real estate, eg plant and machinery, chattels etc there may be a point in saying that these things can be reliably measured and according to standards.
Paragraph 192 page 41	Evolution of the Accord	This is mentioned almost as an aside. It is a useful paragraph which could reasonably apply to the evolutionary process that applies to all standards.Valuers could show a commonality of experience!
Paragraph 233 page 49	Requirements for LGD under the Foundation Approach	This still refers back to footnote 14 of para 38 of the New Basel Capital Accord by mention of the criteria for eligibility.
Paragraph 234 page 49	As above.	Excludes "raw land". This seems rather an all embracing term and might be said to exclude agricultural land. However the point is fairly made about interdependence of the performance of the borrower and collateral.
Paragraph 235 page 49 & 50	Management of collateral	Mentions the need to be able to attach an objective value to the collateral.

Chapter 3: IRB Framework for Retail Exposures

Reference	Subject	Comment
Paragraph 323 Page 66	Maturity as a factor in measuring risk on retail exposures.	Recognises that residential mortgages make up a significant portion of retail portfolios. Many banks go direct to Expected Loss rather than deriving it from the product of PD and LGD. The measurement of EL entails valuations of RRE. Whereas mortgages at the outset tend to occur close to transactions, valuations, done in accordance with acceptable standards have a part to play.
Paragraph 340 page 69	Risk segmentation	By recognising that additional techniques may be employed in segmenting risk exposures for retail portfolios and then specifically identifying "different levels of LTV measures for secured loans;" this would seem to sanction use of MLV.

Chapter 7: Key Issues in Developing an IRB Approach to Project Finance

Reference	Subject	Comment
Paragraph 400 page 84	Risks relating to project finance.	Recognises that "values can be volatile and/or difficult to establish and may evolve over the life of the project. Valuers (operating in accordance with standards) are skilled at undertaking appraisals and assessing risks in real estate development projects.
Paragraph 402 page 85	As above	As above.
Paragraph 404 page 85	As above	With real estate project finance valuers are accustomed to working with the various projections and can attest to the reliability of assumptions.

OPERATIONAL RISK

There are no specific references in this paper. Once again its tenor is one of measurement and validation of data on risk including the continuing maintenance of data on loss events relative to the business undertaken. Paragraph 41 page 12 states "Additional standards are intended to ensure the integrity of the measurement approach, data quality and the risk management control environment".These are the kinds of concepts that valuation standards espouse.

ASSET SECURITISATION

Supporting document to the New Basel Capital Accord

Overview

Reference	Subject	Comment
Paragraph 1 page 1	Overview	In Asset Backed Securities property is frequently the asset and this comprises a significant element of this kind of business. Standards for the measurement of the assets should comprise an integral part of banking procedures.
Paragraph 38 page 9	Liquidity facilities	Role of RRE and CRE acknowledged in ABCP.
Paragraph 40 page 9	Credit protection.	Overcollateralisation identified as a means of credit protection. Only valid if extent of collateral can be reliably and consistently measured.

CRITERIA IN DEFINING EXCEPTIONAL TREATMENT OF COMMERCIAL REAL ESTATE LENDING

Supplement to the New Basel Capital Accord

Introduction

Reference	Subject	Comment
Paragraph 2 page 1	Qualifications for special treatment.	3. Market Value needs to be linked to a definition and to a set of standards. It seems odd to recognise a very specific risk assessment technique in connection with an exception without recognising some standards to shore it up. 2.The wording in the latter part of the paragraph appears defective. " ...or 60% of loan-to-value ratio (LTV) based on Mortgage Lending Value (MLV)...".The wording is inconsistent with that used in Footnote 14 to paragraph 38 in the New Basel Capital Accord. Is not what is intended "...60% of Mortgage Lending Value." Surely the LTV is represented by the %,either 50 or 60, of either Market Value or MLV respectively. 3. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA does define. Some argue that it is incapable of objective measurement.

1. Criteria

Reference	Subject	Comment
Paragraph 3 page 1.	Definition of Commercial real estate lending.	This would appear to imply that this relates solely to let commercial investment property and is therefore at odds with Footnotes 14 and 30.NBCA.The meaning of "mortgages in the form of leases" is not entirely clear.
Paragraph 4 page 2	Excluded property types	This would appear to exclude agricultural land.
Paragraph 6 page 2	Market value and Mortgage Lending Value.	Requires both Mortgage Lending Value and Market Value to be determined.
Paragraph 7 page 3	Definition of Market Value	The paper uses the European Union definition of Market Value, devised for insurance legislation and does not link to any of the definitions advocated by any international valuation standard. It is close to but not the same as the USPAP definition.As a stand alone definition it does not have the back up and force of a set of standards behind it which also embody best practice. We should recommend the IVSC definition as having international acceptance with a set of standards to support it.
Paragraph 9 page 3	Mortgage Lending Value.	This is a concept accepted and used in a few countries. It is intended to reflect a "smoothing" effect on cycles. This is not an widely accepted approach, would be not be permitted under regulation in certain countries, and is considered to be somewhat subjective by some.

II. Verification

Reference	Subject	Comment
Paragraph 17 (3) page 5	Sufficiently long historic experience.	Continues the "60% of the LTV..." inconsistency. See comment on Para 2 page 1.
Paragraph 20 (b) page 7	Country level disclosure.	As above.

Annex – Valuation Rules

This sets out a methodology for Mortgage Lending Value. This would appear to be a unique departure for the Accord insofar as it tends to avoid prescription of detailed methodology when referring to professional disciplines other than banking.

Reference	Subject	Comment
Paragraph 3 page 12 first bullet.	Value of yield.	Given that the language chosen is English, this is not very clearly expressed. Perhaps what is meant is that value of yield is based on " a level of gross rent which is regarded as sustainable through different market cycles and affordable to the generality of tenants.

INTERNATIONAL VALUATION STANDARDS COMMITTEE

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Bank for International Settlements
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15 May 2001

By email to BCBS.Capital@bis.org

Dear Sirs,

Consultation on the New Basel Capital Accord

We wish to participate in the consultancy on the New Basel Capital Accord (Basel 2) and present our response in 3 parts:

1.The background and credentials of IVSC.
2.A review of the framework of Basel 2 and how IVSC see scope for mutual benefit through recognition of property valuation standards.
3.A detailed review of the entire consultancy documents highlighting areas where property matters are referred to and making specific comments.

In making our response, we are fully aware that property is but one aspect of Basel 2 and we take care to keep a perspective on the importance of real estate issues and indeed the contribution of the valuation profession to the matters addressed. Notwithstanding,property is an important form of collateral and we do feel able to make representation on behalf of the valuation profession globally having made a detailed study of Basel 2. Banks are a very important part of the customer base for valuation services and accordingly our standards are there to meet, and be adapted to, their needs. We hope that this response will stimulate a closer working relationship and regular dialogue between the Committee, the banking industry, its supervisors and the valuation profession to promote a better understanding of property and its value as collateral.

Cont./...

1. International Valuation Standards Committee (IVSC)

1.1 The IVSC is an unincorporated association comprising professional valuation associations from some 50 countries.The IVSC is an NGO (Non Government Organisation) member of the United Nations.IVSC maintains liaison with international agencies, such as the Organisation for Economic Co-operation and Development (OECD), the World Bank, the International Monetary Fund, the World Trade Organisation, the European Commission, and the Bank for International Settlements. IVSC also maintains a close relationship with standard setting bodies such as the International Accounting Standards Board (previously the International Accounting Standards Committee), the International Federation of Accountants, and the International Organisation of Securities Commissions.

1.2 The IVSC has published International Valuation Standards (IVS) since 1985. The Standards, and accompanying Guidance, reflect the collective thoughts, experiences, and professional judgements of Valuers from 50 countries. They are recognised throughout the world and have been incorporated into the domestic standards of many nations.

1.3 In January 2000, the IVSC commenced a three year Standards Project with the objective that by 2002, the IVSC will have published a set of comprehensive and robust international standards that will facilitate cross-border transactions involving property and contribute to the viability of global markets by promoting transparency in financial reporting. The Standards issued under the Project represent a development of earlier editions of IVSC Standards, not a departure from them.A copy of the 2000 edition of International Valuation Standards,launched last July 2000 will be made available to members of the Basel Committee. The 2001 edition will be available at the end of July.

1.4 In January 2001 IVSC convened an Expert Working Group (see Annex A for membership) to make recommendations on the revision of International Valuation Application 2,Valuation for Lending Purposes. Part of the brief of that Group was to give consideration to Basel 2. A sub-group was formed comprising Andrew Cherry (Chairman of the Expert Group),John Rich (IVSC Technical Consultant) and Marianne Tissier (Executive Director, IVSC) specifically to consider Basel 2 and report to the Group. The former two members of the sub-group visited the offices of the Committee in February 2001 and met with Karl Cordewener and Bengt Mettinger to discuss Basel 2 and explore the opportunities for future cooperation between the two Committees.

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2. Comments on Basel 2 framework from property perspective.

2.1 **Recognition of Standards.** In developing its framework, the Basel Committee acknowledges,in several places, the part that can be played by external agencies in supporting the regulatory proposals. For example, under the Standardised Approach, Export Credit Agencies and external credit assessment institutions (ECAIs) are to play a key role in the allocation of risk weights. The Committee state that they will continue to work with accounting authorities,including the International Accounting Standards Committee (IASC),to promote consistency between disclosure frameworks. However, nowhere in the consultation documents is there any acknowledgement of the role of standard setting in the context of real estate valuation and its (self) regulation. This carries important consequences because, without such acknowledgement, Basel 2 deprives itself of a whole raft of widely understood concepts of best practice and accepted definitions within the profession charged with the measurement of an important form of collateral, property. We would draw attention to the work of the Financial Stability Forum in fostering the implementation of international standards relevant for sound financial systems. Whilst acknowledging that International Valuation Standards are not one of the 12 identified key standards,nonetheless,the objectives of FSF and IVSC do coincide.

2.2. **Definition of Market Value and other property terminology.** There are areas in the consultation which will lead to confusion and uncertainty both amongst banks and those they call upon to measure collateral. Perhaps the most striking point is the definition of Market Value itself. There is now a single definition widely accepted throughout the valuation world, which is not only set out, but also given a very detailed description and supporting framework in InternationalValuation Standards.This is reproduced in many national standards. By embracing a term which is understood by the profession charged with its measurement Basel 2 would capture the entire supporting framework behind the definition.In practice what is currently proposed is a definition drawn from the European Union which was specifically devised to cover insurance legislation, and again was done so without proper consultation with valuers and in apparent disregard of a widely accepted existing definition.The difference in the definition may be minor and of little practical consequence but without the linkage to standards on implementation it undermines the efforts the valuation profession is striving to make to improve its performance. Further, it leaves the architect of the definition to support it with its own set of standards,or worse still unsupported at all by wider standards and codes. Throughout the consultation there are other allusions to matters relating to property valuation which are casually drawn and again not linked to accepted practice or definitions amongst valuers. For example at paragraph 318 of the NBCA reference is made to objective market value, followed by a diluted description mixed with accountancy terminology.

Cont./...

2.3 **Evolution of working practices.** Paragraph 38 of the NBCA passes a fairly damning indictment of commercial real estate as a collateral for lending. However, we would contend that it has not solely been down to the sometimes volatile performance of property itself that has been the cause of troubled assets.The risks involved in real estate lending are multi-layered and different as between countries.They include factors such as bank lending practices, laws on mortgages, foreclosure and bankruptcy as well as the quality of valuation advice and standards. It is all of these that the development of banking and valuation standards tries to address. Like the banking industry, the property valuation profession has been trying to improve its procedures and work towards globally agreed standards and definitions through the International Valuation Standards Committee (IVSC). Like the Basel Committee, the IVSC is made up of representative members of national professional bodies, and, increasingly, the latter are adapting their own national standards to incorporate IVS. Recognition and dialogue by the Committee with the valuation profession would bring expertise on a particularly important risk mitigant,property.We would observe that as our enquiry progressed,it became increasingly apparent that there was surprisingly inadequate statistical data and analysis available on commercial property lending (regardless of detailed definition, see below) either globally, regionally or locally in most countries,to support the IRB approach or the exceptional treatment.

2.4 **Property as loan collateral.** Commercial real estate (CRE) is referred to repeatedly in the consultation documents not least in the context of paragraph 38 referring to the poor historic lending experience. However, only one attempt to define CRE is made in the NBCA document itself and that is at paragraph 313 in the context of corporate loans.This effectively refers purely to what might be better described as operational property (as covered under International Accounting Standard IAS 16,Property, Plant and Equipment). It specifically excludes let CRE or investment grade property. Valuers could probably agree that CRE, as defined, is the least reliable collateral, the hardest to value accurately, and the most volatile, suffering most when economic circumstances increase the possibilities of default. Indeed, in some states it is sometimes valued on an inappropriate (non- market) Depreciated Replacement Cost approach.

Confusingly, in Footnotes 14 to paragraph 38, and 30 to paragraph 207 NBCA *"recognises that, in exceptional circumstances for well-developed and long- established markets, mortgages on office and/or multi-purpose commercial premises and/or multi-tenanted commercial premises.....".* Yet, in the "Criteria in defining exceptional treatment of commercial real estate lending", paragraph 3 the definition of commercial real estate lending refers only to *"a mortgage of approved currently income-producing property....".* The latter clearly confines itself to let investment property whilst the former is wider.

Cont./...

It is unclear if this distinction is intentional. It is our understanding that the wider definition used in footnote 14 was generally intended to reflect existing practices within the European Union with loans secured on certain kinds of property occupied and owned by small and medium sized entities (SMEs). Property meeting this definition is frequently the only form of available collateral that SMEs are able to offer.

We would consider that income producing investment property, seemingly as defined in paragraph 3 of the "Criteria", and as defined in IAS 40, but perhaps with the additional riders set out in paragraph 4,page 2 of the "Criteria", would provide the safest form of collateral and should perhaps be recognised as such. Footnote 30 page 42 under the IRB(F) is consistent with Footnote 14 and, by including "offices and/or multi-purpose commercial premises"(without the rider of them having to be let) envisages a wider definition offering a somewhat different risk profile. We appreciate that IRB(F) is categorising loans into broad bands of business type. We believe that Basel 2 needs to clarify the range of property to which it intends that the exceptional treatment may be applied. For the purposes of this response, and having regard to the background, we are assuming that it is the wider definition envisaged under Footnotes 14 and 30.

2.5 **The Exceptional Treatment.** Whilst it is not our place, nor would we wish, to recommend changes to the construction and development of the Accord, we would nonetheless observe that the Exceptional Treatment is itself inconsistent with the remainder of the consultation documents. It indulges in an unusual depth of detailed methodology of a discipline, property valuation, completely divorced from normal banking routines, yet it still pays no cognizance to any of the valuation industry's standards. We understand that it evolved as a compromise seeking a way forward through some stridently held positions. The resultant paper has not enjoyed the same attention to detail and language as the main Basel 2 documents. The working language of the Committee is English and generally the NBCA and supporting documents are grammatically near perfect. However, this cannot be said of the Exceptional Treatment document. Whilst its general intentions are usually clear the expression is imprecise and conceptual so there will be scope for misunderstanding when it comes to be translated into other languages.

We are aware of the circumstances necessitating the development of the Exceptional Treatment and its origins in the derogations permitted under EC Directive 89/647 (as amended). In particular, that it is directed at a few states which have well established markets in commercial mortgages, which maintain detailed data to support their lending experience, have enacted legislation, and have generally enjoyed stable markets over long periods.

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We have drawn attention above to the apparent discrepancy between the kind of property referred to in footnote 14 and the different description used in paragraph 3 of "criteria". If our observation is correct, then the definition of commercial real estate lending, as currently proposed in "criteria", in fact excludes a particular class of property collateral which the EU derogation was designed to include.

Our enquiries have suggested that there are two prevailing views as to the future extent of the adoption of the exceptional treatment under Basel 2. One view holds that the criteria are so tightly drawn that its application will be limited to certain countries in the EU and in due course the incentives available under IRB(A) will see it progressively fade away. The alternative view is that the economic benefits of the lower risk weightings and the lower operational costs of the Standardised approach will encourage its wider use particularly amongst smaller banks. This has implications for IVSC.

If the application of the exceptional treatment were to be localised and limited to a relatively few countries with well-established existing routines, then the detail and methodology of implementation would not ordinarily be subject of International Valuation Standards. However, if, in the pursuit of a level playing field for global financial harmonisation, an increasing number of countries (particularly outside Europe) put in place the necessary regulations to meet "the Criteria" then IVSC would see a need to introduce appropriate standards.

Mortgage Lending Value (MLV), as a central plank to the exceptional treatment, is rarely recognised or used by valuers outside Europe. As one of a number of risk assessment or "value at risk" techniques it would not ordinarily qualify for inclusion in International Valuation Standards. However, given its derivation from Market Value indicators, the preparation of a MLV assessment would properly fall into the skill range of valuers. As such, if it were to become a service requirement of the global banking community, then IVSC would respond by developing appropriate standards drawing on the long-term experience of its European members. Guidance on Mortgage Lending Value is currently given by The European Group of Valuers' Associations (TEGoVA) based upon the European Union definition.

In summary we would make the following specific points:

◆ We suggest that "Investment Property" (linked to IAS 40) or a term such as "Income producing Investment Property" could justify specific recognition as the safest form of property collateral, underwritten as it is by a debt servicing cash flow from a third party tenant. At present, this is dealt with merely as an adjunct in the exceptional treatment.

Cont./...

◆ The subject of definitions,such as Commercial Real Estate, needs addressing for consistency of use in the different contexts of the whole Accord.The Committee should clarify the range of property to which it intends that the exceptional treatment should apply.

◆ We consider that the circumstances and limits of the application of the exceptional treatment are matters for the banking community, but that property valuation aspects of its implementation could be better developed in conjunction with standard setters for the property valuation profession.

◆ We consider that the various rules applying to the countries adopting the Exceptional Treatment, as set out in sub-paragraphs 1-4 of Verification will themselves limit the wider application owing to the general lack of the required statistical data.With these safeguards in place, Market Value provides a satisfactory basis upon which to base various risk assessment techniques, of which Mortgage Lending Value (MLV) is one and we would therefore question the need for prescription. MLV is a technique well understood, tried and tested in certain European countries but not so well understood or necessarily suitable for use in other parts of the world. We consider that if the same rules as outlined above from Verification, were applied to data assessed by reference to Market Value, a similar outcome would prevail. Notably the Exceptional Treatment would remain limited to a relatively few stable economies in Europe for many years, and until the requisite supporting data had been maintained for sufficient time. For sophisticated banks this would appear to be entirely compatible with IRB(A) whilst smaller banks might depend on communal assembly of such data.

◆ In the event that the Committee envisage growth in the application of the exceptional treatment we would urge them to support IVSC in further developing the concepts and methodology set out in "Criteria".

3. Detailed review of the consultancy documents

A detailed review of the entire consultancy documents highlighting areas where property matters are referred to and making specific comment is at Annex B.

In conclusion, there is growing recognition that the various international standards being developed must be mutually supportive. The International Accounting Standards Board has acknowledged the importance of International Valuation Standards to the rigorous and consistent application of International Accounting Standards. Reference to International Valuation Standards appears in IAS 40, Investment Property.

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The International Monetary Fund, in its Staff Comments on the Proposals of the Basel Committee for a New Capital Adequacy Framework (24 February 2000) said that without proper rules on asset valuation any capital adequacy assessment is bound to be misleading and called for rapid progress to provide guidance or standards for asset valuation.

The IVSC strongly urges the Basel Committee to recognise the International Valuation Standards. By so doing, the provisions of the Capital Accord would be strengthened. Adherence to International Valuation Standards would appear to be entirely consistent with the concept of the progression towards Advanced Internal Ratings Based approach. At the same time, recognition within Basel 2 would also strengthen the ability of valuation standard setters to develop and further improve their standards and gain wider global recognition and adherence.

The IVSC would be pleased to discuss its comments further with members of the Committee.

Yours faithfully,

Greg McNamara, LFAPI, A.I.Arb.A
Chairman, International Valuation Standards Committee

INTERNATIONAL VALUATION STANDARDS COMMITTEE

ANNEX A

MEMBERSHIP OF IVSC EXPERT GROUP ON BANK LENDING VALUATIONS

Chairman – Andrew Cherry, Partner, Healey & Baker, London

Technical Consultant – John Rich, MA

Members –

Daiva Albertaviciene, Director, Property Valuation Dept., Vilniaus Bankus, Lithuania
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Philip Cropper, Senior Director, CB Hillier Parker, London
Alex Hesterberg, Managing Director, Deutsche Bank, New York
Raymond Trotz, Executive Vice President, Head of Real Estate Clients, HypoVereinsbank, Munich; Chairman, Valuation Committee, German Mortgage Federation

Special recognition is given to Wolfgang Kalberer, Verband Deutscher Hypothekenbanken for his aid in understanding a number of issues.

ANNEX B

Overview of the New Basel Capital Accord

Reference	Subject	Comment
Paragraph 34 page 7	Other professional standards and regulations	We would hope that International Valuation Standards could also be recognised in this area.
Paragraph 43 page 9	The effect of cycles.	This is an area where we believe that the property profession could assist with research and data on property market cycles.

The New Basel Capital Accord

Reference	Subject	Comment
Paragraph 38 page 11 Footnote 14	Introduces Exceptional Treatment	1.The wording in the latter part of the note appears defective. " ...or 60% of loan-to-value (LTV) based on Mortgage Lending Value (MLV)...". Further, the wording is inconsistent insofar as para 2 of Supplement – "Criteria in defining exceptional treatment....." includes the word "ratio". Is not what is intended "...60% of Mortgage Lending Value.." as appears in the first sentence of the footnote? Surely the LTV is represented by the %, either 50 or 60, of either Market Value or MLV respectively. 2. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA publish guidance.

Reference	Subject	Comment
Paragraphs 312-315 page 57	Commercial and Residential Real Estate as collateral for corporate loans.	This seems to specifically exclude properties let as investments from being regarded as collateral for corporate loans. This section is held out as providing a definition of commercial real estate, which it is not. It is describing the particular circumstances of corporate loans collateralised by real estate owned and usually occupied by the borrower. We consider it could be better termed "Operational Real Estate" or "Owner Occupied Real Estate" and perhaps tied to IAS 16.
Paragraph 318 page 58	Objective Market Value of Collateral	This paragraph would appear to introduce a number of concepts without linking them to any other standard. Fair Value is an accounting term defined by IASC and other standards. "...at or less..." would give legitimacy to any conservative valuation method, however the rest of the definition seems to embrace much of the Market Value definition under IVSC. There must be scope to tie this paragraph to other professional measurement standards.
Paragraph 321 page 58	Additional collateral management requirements in order to meet operational needs.	Whilst this section is about managing collateral it does identify the need to be able to "establish objectively a price or market value....."

Reference	Subject	Comment
Paragraph 655 page 123	Qualitative disclosures.	This provides another area where one could commend the ideas of standards for the measurement of collateral.

THE STANDARDISED APPROACH TO CREDIT RISK

Reference	Subject	Comment
Paragraph 42 page 9 Footnote 8	Risk weights of claims secured on commercial real estate.	1.Allocates a 100% (standard) risk weight to commercial real estate lending but recognises the Exceptional Treatment. Footnote 8 is a restatement of Footnote 14 to paragraph 38 of the New Basel Capital Accord. 2.The wording in the latter part of the note appears defective. " ...or 60% of loan-to-value (LTV) based on Mortgage Lending Value (MLV)...". Further, the wording is inconsistent insofar as para 2 of Supplement – "Criteria in defining exceptional treatment....." includes the word "ratio". Is not what is intended "...60% of Mortgage Lending Value.." as appears in the first sentence of the footnote. Surely the LTV is represented by the %, either 50 or 60, of either Market Value or MLV respectively. 3. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA publish guidance.

Reference	Subject	Comment
Paragraph 105 Page 19	Benchmarking	There are now benchmarks for real estate performance which are based on valuations and also indices.
Paragraph 110 Page 19	Eligible collateral	" Essential that collateral can be revalued reliably".This is the essence of valuation standards.

THE INTERNAL RATINGS-BASED APPROACH
Supporting document to the New Basel Capital Accord

Reference	Subject	Comment
Paragraphs 91 - 98 pages 20 & 21	Eligible commercial and residential real estate under the foundation approach (of the internal ratings based approach).	By referring this section back to the New Basel Capital Accord this links this section of the foundation approach of IRB back to the eligible criteria under footnote 14 of para 38. Reference to the amount of collateral in para 93 implies valuations. Para 96 makes no reference as to how the collateral value is to be measured in determining the LTV ratio.
Paragraph 96 page 21	Other forms of collateral.	Property other than pure real estate, eg plant and machinery, chattels etc can be reliably measured by valuers according to International Valuation Standards.
Paragraph 235 page 49 & 50	Management of collateral	Mentions the need to be able to attach an objective value to the collateral.
Paragraph 400 to 404 page 84	Risks relating to project finance.	Valuers are able to assist in assessing risks and reliability of assumptions in real estate development projects.

ASSET SECURITISATION

Supporting document to the New Basel Capital Accord

Reference	Subject	Comment
Paragraph 1 page 1	Overview	In Asset Backed Securities property is frequently the asset and this comprises a significant element of this kind of business. Standards for the measurement of the assets should comprise an integral part of banking procedures.
Paragraph 40 page 9	Credit protection.	Overcollateralisation identified as a means of credit protection. Only valid if extent of collateral can be reliably and consistently measured.

CRITERIA IN DEFINING EXCEPTIONAL TREATMENT OF COMMERCIAL REAL ESTATE LENDING

Supplement to the New Basel Capital Accord

Reference	Subject	Comment
Paragraph 2 page 1	Qualifications for special treatment.	1. Market Value needs to be linked to a definition and to a set of standards. It seems odd to recognise a very specific risk assessment technique in connection with an exception without recognising some standards to shore it up. 2.The wording in the latter part of the paragraph appears defective. " ...or 60% of loan-to-value ratio (LTV) based on Mortgage Lending Value (MLV)...".The wording is inconsistent with that used in Footnote 14 to paragraph 38 in the New Basel Capital Accord.Is not what is intended "...60% of Mortgage Lending Value." Surely the LTV

Reference	Subject	Comment
		is represented by the %,either 50 or 60, of either Market Value or MLV respectively. 3. Mortgage Lending Value is not a term universally understood or accepted. There is currently no IVSC definition, but TEGoVA publish guidance.
Paragraph 3 page 1.	Definition of Commercial real estate lending.	This would appear to imply that this relates solely to let commercial investment property and is therefore at odds with Footnotes 14 and 30.NBCA. Could this be linked to IAS 40, Investment Property.The meaning of "mortgages in the form of leases" is not entirely clear.
Paragraph 7 page 3	Definition of Market Value	The paper uses the European Union definition of Market Value, devised for insurance legislation and does not link to any of the definitions advocated by any international valuation standard. It is close to but not the same as the USPAP definition.As a stand alone definition it does not have the back up and force of a set of standards behind it which also embody best practice. We would recommend the IVSC definition as having international acceptance with a set of standards to support it.

II. Verification

Reference	Subject	Comment
Paragraph 17 (3) page 5	Sufficiently long historic experience.	Continues the "60% of the LTV..." inconsistency. See comment on Para 2 page 1.
Paragraph 20 (b) page 7	Country level disclosure.	As above.

ANNEX - VALUATION RULES

This sets out a methodology for Mortgage Lending Value. This would appear to be a unique departure for the Accord insofar as it tends to avoid prescription of detailed methodology when referring to professional disciplines other than banking.

Reference	Subject	Comment
Paragraph 3 page 12 first bullet.	Value of yield.	Given that the language chosen is English, this is not very clearly expressed. Perhaps what is meant is that value of yield is based on " a level of gross rent which is regarded as sustainable through different market cycles and affordable to the generality of tenants.