

International Valuation Standards Committee

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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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.

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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 states that it 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 International Valuation 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.

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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.

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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 very specific kinds of property occupied and owned by small and medium sized entities (SMEs) and which, in those markets, is considered to offer good security. 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.

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- 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, LFAP, 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

Chiu Kam Kuen, Executive Director, DTZ Debenham Tie Leung, Hong Kong

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

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