



London, 9<sup>th</sup> March 2016

## Response of the EAA to the BCBS second consultative document on 'Revisions to the Standardised Approach for credit risk', published on 10<sup>th</sup> December 2015

### General Comments

The European AVM Alliance (**EAA**)<sup>1</sup> would like to acknowledge the efforts of the Basel Committee regarding the "Second consultative document" on proposed "Revisions to the Standardised Approach for Credit Risk", released on 10<sup>th</sup> December 2015.

In particular the EAA welcomes the new revisions to the **risk-weighting methodologies for real estate exposures** proposed by the BCBS<sup>2</sup> not only when compared to the current Basel II standardised approach (SA) to this exposure class, but also when compared to the BCBS's first set of revisions proposed in the "First Consultation" of December 2014.

The EAA, however, would like to take this opportunity to provide its response, including proposed modifications, to the second consultative document focussing primarily on the BCBS's proposals on risk weighting for **Residential real estate exposures**, since this intrinsically links to the application of **AVMs** (Automated Valuation Models) in valuating residential properties as collateral which is at the core of the expertise of the EAA and its members.

### 1. Loan-to-value (LTV) ratio as principle risk driver

The EAA agrees with the BCBS's assessment that 'one of the key weaknesses of the current SA is the lack of granularity and risk sensitivity in a number of exposure classes'. On the basis of this observation the BCBS rightly proposes 'to increase the risk sensitivity of the SA' including the

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<sup>1</sup> The European AVM Alliance ([EAA](http://eaa.eu)), founded in 2013, is a pan-European alliance consisting of leading providers of Automated Valuation Models (AVMs). The EAA's main aim is to bring about a consistent approach to automated valuations enabling the mortgage lending, investor, rating and regulatory communities to operate in a more transparent and effective way. The overall goal of the EAA is to set the quality standard for AVMs and to promote AVM consistency to drive greater transparency and more effective risk management for mortgage lenders, investors, rating agencies and regulators.

<sup>2</sup> 'Revisions to the Standardised Approach for credit risk' – 'Second consultative document', Annex I, 9. Real estate exposure class, §§ 49-56, p. 34-36.



example of ‘enhanced risk sensitivity for real estate exposures [...] by introducing the LTV ratio as a risk driver’.<sup>3</sup>

In its 2014 consultative document the BCBS proposed to assign risk weights for residential real estate exposures based on two risk drivers: loan-to-value (LTV) ratio, and the debt servicing coverage (DSC) ratio, as a proxy of the borrower’s ability to service the mortgage.

In the second consultative document the BCBS has now modified this approach by proposing to drop the DSC entirely and to leave only the LTV ratio as the main and principle risk driver for weighting purposes.

## **2. Frequent Monitoring of property value essential for credit risk exposures**

While the EAA fully agrees that the LTV ratio is the best indicator for setting risk weights in general and therefore supports this revisions proposed by the BSBC, the EAA does not agree with the BSBC’s proposal that ‘the value of the property [ie the denominator of the LTV ratio] will be maintained at the value measured at origination unless national supervisors elect to requires banks to revise the property value downward’.<sup>4</sup>

Exceptions to the above recommendations are only foreseen under exceptional circumstances: ‘The value must be adjusted if an extraordinary, idiosyncratic event occurs resulting in a permanent reduction of the property value. Modifications made to the property that unequivocally increase its value could also be considered in the LTV’.<sup>5</sup> In addition, the LTV ratio shall also be calculated ‘prudently’<sup>6</sup>, according the BSBC’s recommendations.

In the opinion of the EAA, prudence with regard to the LTV ratio can better be achieved, if the value of the property is not – except specific circumstances – kept at the value calculated at origination, but instead monitored frequently, in order to avoid the lack of risk sensitivity that the current SA shows. It is of fundamental importance that the LTV ratio is not by default based on the original value of a residential property at origination, but, whenever possible and available, on the **current value**.

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<sup>3</sup> p. 22

<sup>4</sup> § 52, p. 35

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.



The EAA has the view that a bank should have at least have the choice whether to use the original or the current valuation, especially since the use of current valuation in the LTV ratio is a much more precise and accurate measure of the current risk for the following reasons:

Over time the LTV ratio evolves, not only due to the repayment of the loan, but also – and primarily so – due to house price movements, both up or down. To reflect this fluctuation in property values the setting and annual monitoring of risk weights should always be based on the current LTV ratios as these accurately mirror the current ‘risk’ in the housing market. For instance: if house prices go down, a borrower is more likely to default as they have less equity in their home.

The general exceptions for basing the LTV ratio on the property value at origination proposed by the BCBS (ie in case of a general, national, decline in residential property prices a revision of the value may be required by the supervisor), are not enough and may not have the intended impact. The reason for this lies in the observation that house price fluctuations do not always occur nationwide, but can differ greatly by geographic or even local regions.

While some regions might show a positive market price trend, other regions can see prices declining at the same time. Hence the geographic distribution of a bank’s property portfolio has to be taken into account, and this can only be achieved by frequently monitoring the property valuations of a bank through a continuous, geographically granular, accurate and reliable valuation method.

### **3. Requirements for property valuation**

The proposed requirements for determining the value of a property as set out in the second consultation document state:

*Value of the property: the valuation must be appraised independently using prudently conservative valuation criteria. To ensure that the value of the property is appraised in a prudently conservative manner, this value must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. National authorities should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law. If a market*



*value can be determined, the valuation should not be higher than the market value.*<sup>7</sup>

Footnote 46 further states that ‘The valuation must be done independently from the bank’s mortgage acquisition, loan processing and loan decision process’.<sup>8</sup>

Only if these criteria are met does the valuation process conform to and meet the requirements of granularity and risk sensitivity in a revised SA which the current SA – as analysed by the BCBS above – currently lacks.

The use of **AVMs** (Automated Valuation Models) fulfils all the above requirements and provides an independent, unbiased, transparent and objective valuation process that yields the most reliable and accurate valuations. AVMs do so in a way that is far superior to other, existing valuation process based on chartered surveyors or house price indices which each have their potential shortcomings.

#### **4. Valuations of property values based on AVMs**

As a result of using an AVM the determination of the actual value of collateral is improved, thus leading to a better functioning and efficiency of markets. These AVMs are now increasingly used by banks and other stakeholders within the mortgage and real estate industries, especially for valuing entire property portfolios.

AVMs provide a value estimate for any given property using sophisticated mathematical modelling techniques in an automated and, hence, entirely objective manner. An AVM is a uniquely valuable tool for risk managers who need to accurately monitor and update the market value of residential property portfolios for credit risk mitigation and regulatory compliance, and to provide an indication of value for investors and consumers or to update the market value of the underlying collateral within structured finance products such as RMBS and Covered Bonds.

- An AVM does not require a previous property value as input and thus does not carry forward any bias, fraud or excessive optimism that might have been present in the original valuations
- An AVM is able to value properties where no previous transaction is known to the party requiring the valuation, thus making up for any missing data within the mortgage book

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<sup>7</sup> Ibid.

<sup>8</sup> Ibid.



- An AVM is demonstrably more accurate and therefore more reliable than the traditional portfolio revaluation methodology through indices; this can be shown in a simple and scientific manner in extensive empirical tests conducted on large data samples from, e.g. Italian residential property portfolios
- An AVM includes a Confidence Level for each valuation result, thus providing risk managers with an indication of accuracy at a property-by-property level and allowing them to achieve much greater granularity in their models than with any other approach. Unique or non-standard properties are harder to value than standard properties, which would result in a low Confidence Level. This is important information to the user of these valuations, as in how much confidence they can place in the valuations itself
- Confidence Levels also form the basis of the Rating Agencies' published treatment of AVMs, resulting in much lower "haircuts" than those applied to indexation.

The EAA would therefore recommend to the BCBS to include the use of AVMs as one of the valuation methods for determining the value of residential properties in the revised SA for credit risk.

For the potential disadvantages in the use of other valuation methods see **Appendix I**.

Arjen Wink  
Chairman

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## **Appendix I**

### **1. Potential non-independence and lack of transparency in chartered surveyors' valuations**

Chartered surveyors, who undertake valuations of properties, are usually instructed either by the bank who issues the bond, or by the borrower, who is taking out a loan. In either case there is a potential conflict of interest, and there is a chance that despite the best efforts the result of valuation process may be bias towards the bank or the borrower; therefore there is no guarantee that the valuation process is fully objective, unbiased and independent. Particularly in cases where the surveyor acts on behalf of the borrower, who actually appoints the surveyor and remunerated them for their services, the valuations may in all likelihood have a positive bias.

In short, the valuation process using chartered surveyors do not fully ensure that the transparency and independence principles set out in the BCBS's recommendations are fully met.

### **2. Index-based valuations potentially non-transparent and biased**

Traditionally the vast majority of revaluations of residential properties is carried out by using national house price indices available in many jurisdictions such as those provided by the respective national offices of statistics. There are, however, indisputable and demonstrable disadvantages in an index-based revaluation, which include:

- An index is merely an average house price development for a large regional area; as a result smaller regions within this area can show a vastly different house price developments compared to the average that the index suggests.
- An index requires a previous property valuation; as a result therefore the bias und inaccuracies included in this previous evaluation, which in the worst case may even include fraudulent intent or excessive optimism that might have been present in the valuation at origination, will be carried forward in an index based valuation
- An indexed valuation has no reliability indicator or Confidence Level, and thus lacks a predictive measure expressing the estimated accuracy of each valuation. This is of particular importance when valuing unique or non-standard properties since these are much harder to value than standard properties and would potentially results in a low Confidence Level. This, however, is very important information for any user of the valuations in terms of risk



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assessment and an indication of how much trust they can place in the valuation itself.

As a result index based valuations at origination or at any point of revaluation of residential properties or entire property portfolios are prone to carry a high degree of uncertainty and bias.

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