

The Regulation on the Determination of the Mortgage Lending Value – Greater Safety in Valuation for Mortgage Purposes

A little over a year after the introduction of the Pfandbrief Act, the Regulation on the Determination of the Mortgage Lending Value (BelWertV) entered into effect on August 1, 2006. In it, property valuation is regulated by law for all Pfandbrief banks. The mortgage banks had previously set standards in many fundamental papers on the mortgage lending value. At many places in the BelWertV, the Federal Financial Supervisory Authority (BaFin) has consistently referred to tried and tested rules of procedure that had previously applied to mortgage banks only. With that, the transparency of the determination of value for the purpose of covering Pfandbriefe has been enhanced appreciably to the benefit of the market participants. This article will give an overview of the BelWertV.

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When the Pfandbrief Act (PfandBG) entered into effect on July 19, 2005, regulations governing the valuation of properties as a precondition for the inclusion of mortgage loans in cover were recast for all Pfandbrief issuers. In formulating the basis of valuation contained in section 16 PfandBG, German legislators took their bearings from section 12 Mortgage Bank Act, which until then had applied solely and directly to private mortgage banks. Moreover, section 16 PfandBG contains requirements concerning the independence of valuers, a definition of the mortgage lending value and the market value as well as the authorization to the Federal Ministry of Finance to issue, in consultation with the Federal Ministry of Justice, a statutory order to standardize valuation requirements within the scope of the determination of the mortgage lending value. According to section 16 par. 4 PfandBG, the Regulation on the Determination of the Mortgage Lending Value (Beleihungswertermittlungsverordnung, BelWertV) contains details on the methodology for and the form of the determination of the mortgage lending value as well as the valuer's minimum qualification requirements, and eases valuation requirements that apply for the most part to residential properties serving as collateral.

Paradigm Change

The formulations of the BelWertV are modeled to a considerable extent on the groundwork done by the then VDH (Association of German Mortgage Banks). The procedural instructions entitled "Essentials of Mortgage Value Estimation" set first standards for homogeneous valuation for Pfandbrief cover purposes. Founded on the expertise of the valuers working at the member institutions, this paper was the first step towards standardizing the methodology for determining the mortgage lending value; however, its implementation was the responsibility of the individual institutions and had to be bilaterally agreed on with BaFin.

Thus, there was a need to inform investors and market participants such as rating agencies. Whereas this individual mode of procedure could be justified by the so-called specialist bank principle applicable to the mortgage banks, the entry into effect of the Pfandbrief Act, which is to say the uniform legal provisions for all Pfandbrief issuers, made it necessary to heighten transparency and to specify the binding legal framework governing not only the methodology and procedures for determining the mortgage lending value but also the valuers' qualifications.

In terms of its scope and detail, the BelWertV takes its bearings from the Regulation on Valuation (WertV) and the Guidelines on Valuation (WertR), which contain the specific form of the determination of the current value and the market value. This indicates that, with the BelWertV, the aim was to create an independent valuation procedure for the mortgage lending value.

In the following, major aspects covered by the BelWertV will be presented, all of which make clear that the determination of the mortgage lending value differs in many respects from the determination of the current value and the market value.

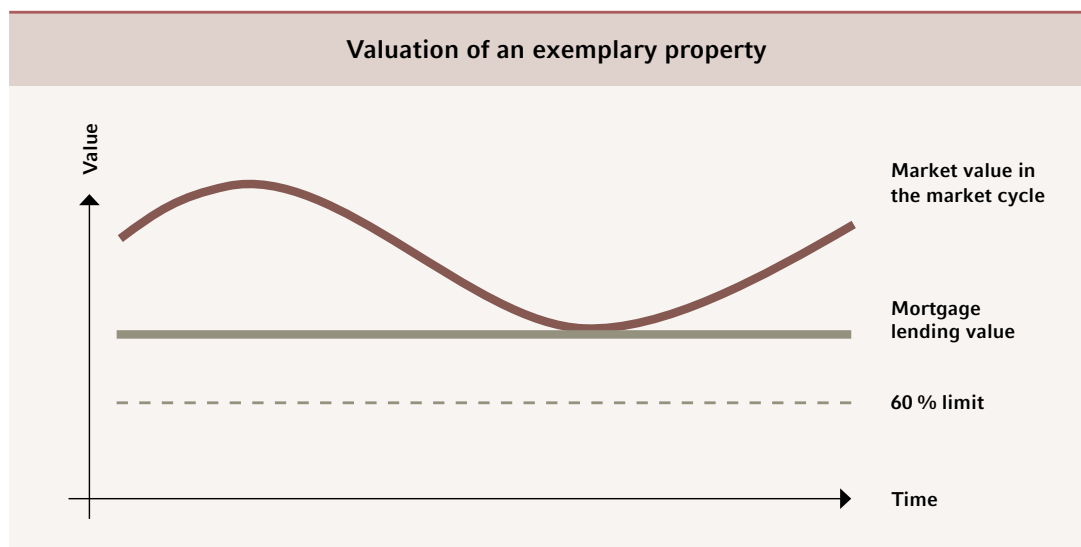
General Provisions and Principles of Procedure

The scope of application of the BelWertV concerns the determination of the mortgage lending values pursuant to section 16 par. 1 and 2 PfandBG. This, then, is the central provision regulating the valuation of real estate collateral that serves to cover Pfandbriefe. The subject of the valuation are real property, rights equivalent to real property (e.g. building leases) or a similar right (e.g. long leasehold in Great Britain) that is or is to be encumbered with a real estate

lien. With the inclusion of the latter, consideration has been given to the rise in the importance of cross-border lending.

In section 3 BelWertV, the principles of the determination of the mortgage lending value are set down which specify the definition of the mortgage lending value pursuant to section 16 par. 2 PfandBG. It is clearly recognizable here that the mortgage lending value has a long-term orientation, i.e. is to exist for a long period of time and may not contain any speculative elements. The difference between it and the market value approach is illustrated in the following chart.

Mortgage lending value and market value: a comparison



The depreciation replacement cost method (“Sachwertverfahren”) and the investment method (“Ertragswertverfahren”) are the main methods specified for determining the mortgage lending value, whereby the calculation steps are analogous to the standardized methods for determining the market value. The depreciation replacement cost value and the income value must be determined separately from each other. Section 4 par. 1 BelWertV retains the so-called two-pillar principle, which has proven itself for decades. Thus, for example, the depreciation replacement cost value is to provide, as a “control value”, in particular information on the sustainability of the income. For the first time, it is provided in the BelWertV that the income value overrides as a general principle the depreciation replacement cost value, and that in cases in which the depreciation replacement cost value is more than 20 % below the income value, the sustainability of the underlying income and the capitalization of same must be reviewed and explained in a manner that is readily comprehensible.

A further point regulated in the BelWertV is that, when valuing owner-occupied apartments and self-contained commercially used units, the comparative value may replace the depreciation replacement cost value. In this point, too, the BelWertV takes its cue from long years of practice and permits the use of the relevant values per square meter of living space for comparable apartments when determining the mortgage lending value of owner-occupied apartments. As an easing measure for the valuation of one- and two-family houses and owner-occupied apartments that are beyond doubt suitable for self-use, the income value need not be determined.

Requirements as to Valuer's Report and Valuer

The BelWertV lays down strict requirements concerning the form of the valuer's report or appraisal and the activity of the valuers who work at or for Pfandbrief banks. For example, reports which are presented or commissioned by the borrower are not permissible. The intention here is to prevent the customer from possibly influencing the amount of the loan. This provision demonstrates yet again that the sole objective of the determination of the mortgage lending value is to value as conservatively as possible the property serving as Pfandbrief cover. It is because of this purely in-house character that mortgage lending value appraisals are not handed over to customers.

The minimum contents of the report are geared to the long-term parameters that are of importance to the financing bank. Valuers' reports must comment on the quality of the property and location, on the regional property market, on the legal and actual features of the property and on the eligibility of the property as collateral, which is to say its usability and leasability. Crucial to the lending is the sustainability of the parameters to be applied. The parameters are based on market observations and analyses of market developments from the past and are projected into the future to shed light on the future usability of the property. The valuer's appraisal must also contain information on alternative appropriate uses, which is to say the possibility of putting the building to another use or of attracting a sufficiently large circle of users or buyers. These requirements, too, underscore the difference between a determination of the mortgage lending value and the determination of the current or market value.

Certified Valuers Assumed to Possess Requisite Qualifications

The demands made on valuers who are to determine the mortgage lending value have been set out in detail in section 6 BelWertV for the first time. The valuer's vocational training and professional activity must show that he possesses specialized knowledge of and experience in valuing real estate. As a rule, a valuer will be assumed to possess both if he has been certified in accordance with ISO/IEC standard 17024 or appointed by a government body. This provision acknowledges the high quality of the valuers who are certified by HypZert (company for the certification of property experts for the assessment of mortgage lending values). For the vdp, which set up HypZert some 10 years ago, this is confirmation of the "quality offensive" launched at that time in the field of valuation. Far more than 700 surveyors have been certified by HypZert in the meantime, this number including primarily heads and executive staff members of the valuers departments at the Pfandbrief banks.

Further, when selecting the valuer, the Pfandbrief bank must convince itself that the valuer has the expertise needed to prepare mortgage lending value reports and, in particular, is knowledgeable about the respective property market and type of property in question.

To ensure the independence of the valuer employed by the bank, his place in the bank's organizational structure must be such that his activity is independent of the loan acquisition and loan decision-making process as well as of the brokering, i.e. the sale or letting, of the property. Nor may the valuer be related to or have a legal or business relationship with the borrower.

Valuation Methods – Tried and Tested Principles Maintained

In its provisions concerning the determination of the income and depreciation replacement cost value, the BelWertV follows to a considerable extent the vdp's papers "Essentials of Mortgage Value Estimation" and "Statement of Principles on the Mortgage Value of Realty". Completed at the end of the 1990s, these two papers are the outcome of many consultations between the Association and Germany's supervisory authority.

The fundamental parameters of determining the income value are described in detail and requirements as to the sustainable quality of the figures are emphasized. Here, too, the difference compared with the determination of the current value and the market value is clearly expressed:

- sustainability of the rental rate (section 10 BelWertV),
- minimum operating expenses (section 11 BelWertV) and
- capitalization of the net income (section 12 BelWertV).

Changes in the determination of the income value as opposed to previous practice, some of which involve a pronounced tightening of requirements, are specified in section 13:

- In cases in which, following the deduction of the interest rate in respect of the land value, no net income remains, the land value – less the usual costs for demolition – is to be applied.
- In the case of buildings with a remaining useful life of less than 30 years, either the income is capitalized in respect of the remaining useful life without stating the land value or the income value is determined stating the land value and the resultant income value is reduced by the demolition costs.
- In cases in which the land value is more than 50 % of the income value, the assumptions on which the determination of the land value was performed must be explained and the preconditions for a replacement building described.

The income value determined depends on the useful life and the capitalization rate. Using these two parameters, the income value is arrived at by way of discounting. It is pleasing to note that ultimately the tried and tested capitalization practice can be retained. One new point in this context, however, is that Annex 2 to the BelWertV makes reference to empirical values for useful lives of individual properties. In some cases, these are considerably shorter than the values previously stated in the Guidelines on Valuation (WertR). For example, useful lives of a maximum of 30 years are provided for leisure properties, self-service and specialty stores as well as petrol stations. This, in connection with section 13 BelWertV, means that when determining the mortgage lending value of new buildings of the type in question, the likely demolition costs must be determined and deducted.

Simplifications for Small Loans

The regulatory simplifications for so-called small loans have been retained with section 24 BelWertV. This provision is aimed above all at low-risk retail business, in the case of which a simplified valuation may be conducted. Valuation requirements are eased in particular in that a sufficiently trained and qualified loan officer may also carry out the valuation. However, this person may not make the final loan decision. The bank is required to conduct random checks to ascertain the good order of the valuation. Gratifyingly, the request of the Central Credit Committee of the Leading Associations of the German Credit Industry (ZKA) has been complied with, and the limit for small loans raised to EUR 400,000 (previously EUR 306,000).

Other new provisions

Three further important provisions warrant mention in the following brief overview:

- Under section 24 par. 4 BelWertV, when loan portfolios are acquired, the valuations that the selling bank or insurance company had carried out may be used as a basis; however, they must be subjected to a plausibility check by means of an adequately representative random sample. If the outcome of the plausibility check is positive, no new valuations need be conducted.
- When loans are extended against properties located abroad, section 25 BelWertV provides that the country-specific reports may be referred to if they are not more than two years old.
- Pursuant to section 26, mortgage lending values must be reviewed if indications exist that the basis for the determination of the mortgage lending value (in particular the price level on the respective regional market) has deteriorated appreciably. What is more – except where owner-occupied residential properties are concerned – a review is necessary if the servicing of the loan in question is in arrears by 90 days or more.

Summary

The BelWertV represents a large step towards a uniform valuation practice. Transparency in valuation has been improved substantially, which ultimately benefits all market participants. The mortgage lending value has been strengthened in its importance as a mainstay of the valuation of collateral covering Pfandbriefe.

Some circles in the German finance sector have misgivings about the general validity of the BelWertV, i.e. that it should also apply in the context of the preferred capital standing for real estate loans. This stance is incomprehensible. The reference contained in the German Banking Act (KWG) to the mortgage lending value pursuant to section 16 par. 1 and 2 PfandBG also contains the application of the BelWertV. The determination of the mortgage lending value cannot be carried out according to a uniform methodology without the specifications in the BelWertV. Non-harmonized methods for determining the mortgage lending value would, on the other hand, impair the transparency, comparability and ultimately also the safety of the mortgage lending value.