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Valuations in European Real Estate Finance – regulatory compliance in a global environment

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In light of the recent ECB guidance on non-performing loans, and in particular the valuation requirements to be adhered to by banks in valuing real estate loans, what are the implications for banks with a global presence? In particular, how should banks subject to FIRREA ensure compliance with both FIRREA requirements and ECB guidance, and would adopting the approach to valuations in the LMA's forms of REF documents suffice?

Introduction

Being a bank with a global presence and being a regulated entity in multiple markets carries with it many complications. The European Central Bank's guidance to banks published on 20 March 2017 ("ECB Guidance") imposes new obligations on significant institutions and their international subsidiaries, in relation to valuation of NPLs. Federally-regulated banking institutions in the United States –most banks and savings associations in the U.S. and their parent companies and nonbank affiliates (again, including their international subsidiaries) – are also required to navigate the FIRREA requirements for valuing real estate in a finance context. And as the provider of standard form documentation for real estate finance deals outside of the US, the Loan Markets Association ("LMA") proposes model definitions and provisions intended to regulate the form, substance, frequency and cost implications of valuations of real estate collateral.

FIRREA Requirements for Real Estate Appraisals

In 1990, the U.S. federal bank regulatory agencies adopted appraisal regulations ("Appraisal Regulations") to implement the real estate appraisal requirements of Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (commonly referred to as "FIRREA"). The Appraisal Regulations require U.S. federally-regulated banking institutions to obtain an appraisal of the value of real estate from a U.S. state-certified or state-licensed appraiser prior to entering into any "real estate-related financial transaction." Such transactions include the sale, lease, purchase, investment in or exchange of, or the financing or refinancing of, real estate or interests therein, as well as the use of real property (or interests therein) as security for a loan or investment, including mortgage-backed securities.

The Appraisal Regulations provide that all appraisals must, at a minimum:

- conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice ("USPAP")[1], unless principles of safe and sound banking require compliance with stricter standards;

[1] Promulgated by the Appraisal Standards Board of the Appraisal Foundation.

- be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;
- analyse and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
- be based upon the definition of "market value" set out in the Appraisal Regulations; and
- be performed by state-licensed or state-certified appraisers as required under the Appraisal Regulations.

Under the Appraisal Regulations, "market value" means "the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus".

The Interagency Appraisal and Evaluation Guidelines ("Appraisal Guidelines") issued in 2010 by the U.S. federal bank regulatory agencies explain that "undue stimulus" refers to favourable financing or seller concessions, which would allow the value of the property to be increased. The Appraisal Guidelines further provide that value opinions such as ''going concern value,'' ''value in use'', or a special value to a specific property user may not be used as market value for required appraisals, and that the estimate of market value should consider the real estate's actual physical condition, use, and zoning as of the effective date of the appraisal.

Neither the Appraisal Regulations nor the Appraisal Guidelines address the issue of how a U.S. federally-regulated banking institution would satisfy the requirement that the appraisal be performed by a state-licensed or state–certified appraiser where the real estate in question, or the branch or subsidiary of the banking institution that is entering into the transaction, is located outside the United States, given that many jurisdictions do not have nationally-registered appraisers or valuers.

Our understanding from the staff of the Federal Reserve Board, is that although the Appraisal Regulations and Appraisal Guidelines apply to non-US branches or subsidiaries of a US federally-regulated banking institution for purposes of determining whether or not an appraisal is required, any appraisal that would have to be obtained would be conducted in accordance with the local standards for valuation of real property in the relevant jurisdiction rather than USPAP. The qualifications required of the valuer would also be those determined by local law and regulation. We expect that the other U.S. federal bank regulatory agencies – primarily , the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation – would take the same approach as the Federal Reserve Board on this issue.

Although the Appraisal Regulations do not specifically require that an appraisal be updated while a real estate-related financial transaction remains on the banking institution's books, the Appraisal Guidelines provide that prudent portfolio-monitoring practices include criteria for determining when to obtain a new appraisal of the real estate, and that those criteria should in particular address any deterioration in the credit since origination or any changes in market conditions.

The Appraisal Guidelines further state that banking institutions should monitor collateral risk on a portfolio basis and on an individual credit basis and have policies and procedures that address the need for obtaining current collateral-valuation information to understand the institution's collateral position over the life of a credit and to effectively manage the risk in its real estate credit portfolios. That is particularly the case for collateral supporting an existing credit that may be modified or considered for a loan workout. This would appear to be the U.S. comparator to the ECB guidance as it relates to NPLs.

In this regard, the Appraisal Guidelines provide that a modification to an existing credit that does not adversely affect the institution's real estate collateral protection does not constitute a new real estate–related financial transaction. A new appraisal (or, under certain circumstances, an appropriate "evaluation" of the real property collateral that is "consistent with safe and sound banking practices") would, however, be required where a loan workout adversely affects the institution's real estate collateral protection or involves a renewal or extension of loan terms, the advancement of new monies, or a restructuring. Those would all constitute a new real estate–related financial transaction for the purposes of the Appraisal Regulations.

ECB “guidance on Collateral Valuation for Immovable Property”

The ECB concluded in the ECB Guidance that, through its supervisory activities, it had discovered deficiencies in the approaches employed by banks in relation to the completeness and accuracy of real estate valuations. Consequently, the ECB set out to assist banks regarding the policies, procedures and disclosures that they should adopt when valuing real estate held as collateral for NPLs. Whilst the ECB Guidance is not enshrined in primary legislation, it is considered mandatory for all “significant institutions” (“SIs”) that are supervised directly under the Single Supervisory Mechanism (“SSM”). SIs are institutions that the ECB has designated as significant based on set criteria: size; economic importance; cross-border activities and direct public financial assistance. A supervised bank can also be considered significant if it is one of the three most significant banks established in a particular country. There are currently 125 institutions designated as SIs by the ECB (as of 1 January 2017). For the purposes of the ECB Guidance, all real estate collateral is eligible regardless of eligibility under the Capital Requirements Regulation[2].

The ECB Guidance on collateral valuations focuses on the role of independent qualified appraisers that possess the necessary qualifications, ability and experience to carry out a valuation. The independence of such appraisers should be tested on a regular basis; amongst other things, appraisers must be segregated from the credit process and should not receive a fee linked to the result of the valuation.

Banks should also carry out more frequent valuations where the market is subject to significant negative changes and/or where there are signs of significant decline in the value of the individual collateral. (The ECB recommends at least yearly in the case of commercial real estate, and more frequently in the event of significant negative market changes, or deterioration in the value of the individual collateral.) Whilst this means that banks must define criteria for assessing when a significant decline in value has taken place, it also raises the question: how is value calculated? Under the ECB Guidance, all real estate collateral should be valued on the basis of market value[3].

The ECB Guidance has adopted the market value test in the Statements of Asset Valuation Practice issued by the Royal Institute of Chartered Surveyors (“RICS”) (commonly referred to as the “Red Book”). Market value is defined as the estimated amount for which an asset or liability should be exchanged on the valuation date between a willing buyer and a willing seller in an arm’s length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

It should be borne in mind that each Member State has its own regulatory framework with respect to its real estate industry. However, in publishing pan-European guidance on collateral valuations, the ECB aimed to harmonise the rules and regulations surrounding real estate valuations and ensure that a consistent approach is adopted across the EU by requiring valuations to comply with European as well as international standards, including those set by the RICS.

LMA standard form/RICS Red Book

The LMA standard form documentation for Real Estate Finance transactions remains (at least on the eastern side of the Atlantic) the market standard for loans backed by real estate collateral. It is worth examining how the LMA documents interact with the FIRREA and ECB rules set out above.

Valuer

The LMA standard form Real Estate Finance facility agreements do not currently specify any requirement for the qualifications of the valuer; the model definition of “Valuer” assumes that parties will agree the names of one or more firms of valuers to fill in the blank and also includes reference to “any other surveyor or valuer appointed by the Agent”. In the US, the requirement for state-licensed and state-certified valuers necessarily requires that the individual appraiser has passed an examination, as well as setting specific requirements of qualification and experience. The licensing/certification relates to an individual appraiser, not a firm. The ECB requires an appraiser to “possess the necessary qualifications, ability and experience” to carry out the valuation. It is uncertain whether the ECB intends to refer to an individual, as the language implies, or to a firm of valuers. In any event, consistent the FIRREA requirements, whoever undertakes the valuation must have a demonstrable level of expertise.

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[2] Regulation (EU) No 575/2013.

[3] Or mortgage lending value (being a lower amount than market value), as permitted by Article 229 of the Capital Requirements Regulation.

Although unlikely to require changes in practice to how a valuation is conducted, for the purposes of demonstrating regulatory compliance, the definition of "Valuer" could be expanded to make explicit reference to the requirement that a "Valuer" must have the necessary qualifications, ability and experience. In addition, Lenders should consider whether to review their valuation instruction letters to make clear that the person signing off on the valuation (from the appointed firm) must have the necessary qualifications, ability and experience – and to require the valuer to include a statement to that effect in the valuation.

A second key aspect applicable to the valuer is independence. Borrowers often seek to negotiate for some consent, or at least consultation, right in relation to the identity of the valuer. Lenders should be wary of this request, given the emphasis (particularly in the ECB Guidance) of the requirement for the valuer's independence. While the valuation will necessarily be instructed by the Lender in any event, the perceived "independence" of the valuer could be compromised to the extent the Borrower has influence over who gets appointed to the task.

Valuation

In terms of the valuation itself, the "market value" referred to in the LMA definition of "Valuation" is the definition of "market value" contained in the Red Book. As mentioned above, that is the same test as in the ECB Guidance. There are also similarities between the Red Book definition and the Appraisal Regulations, although the tests are expressed slightly differently. Both contemplate an arm's length/open market transaction and both equally refer to the requirement for both buyer and seller to be acting "prudently and knowledgeably". Consequently, in our view, a Valuation of the type referred to in the LMA facility agreements should be sufficient from a FIRREA perspective.

Frequency

The LMA model drafting for frequency of Valuations entitles the Agent to request a Valuation at any time. The only constraining aspect of the provision is in relation to the cost of the Valuation. Unless a Valuation has been requested in one of the specified circumstances, it will be at the cost of the Lender. The ECB guidance links the recommendation of frequency of valuation to a significant negative market change. The circumstances listed in the model drafting do not include significant negative market change, although there could be overlap between that occurrence and the Valuation showing a default of an LTV covenant, which might be the result of a significant negative market change. One could take the view that since the Lender is not restricted from requesting a Valuation at any time, but only has to bear the cost, even on the basis of the model drafting a Lender would be able to comply with the ECB guidance. A further option would be to include in the facility agreement a specific entitlement to request a valuation upon the occurrence of a significant negative market change.

In terms of FIRREA compliance, there is no continuing requirement for Valuations to be updated, but rather, a new Valuation should be obtained in the context of certain circumstances (i.e. modifications to the terms of the financing). In such circumstances the Lender is likely to be able to insist on a new Valuation in any event, without the need to rely on the existing terms of the facility agreement.

Best practice for REF lenders in the future?

Where a REF lender is both a U.S. federally-regulated banking institution and an SI (or a subsidiary of an SI), it must be mindful of both U.S. and ECB requirements for valuation of its real estate loans – particularly where the value or performance of those loans drops to such a level as to require formal re-valuation pursuant to the Appraisal Regulations in the U.S. and/or the ECB Guidance.

The key takeaways for lending institutions therefore, seem to be the following:

- to be pro-active in monitoring their positions, and instruct new valuations in the event of deterioration of the credit (whether on a portfolio basis or a single-asset basis) and to be cautious of agreeing any limitations in their facility agreements as to when valuations may be requested if that would preclude valuations from being requested on an annual basis or at other times in the event of significant negative market change;
- to ensure that any valuer is suitably qualified in accordance with the local laws applicable to the real estate collateral and has the necessary qualifications, ability and experience to carry out the valuation and to consider reflecting that requirement in the facility agreement itself;

- to ensure that the valuer is (and is seen to be) independent from the Borrower and also from the Lender (or at the very least, from the credit process) and does not receive a fee linked to the result of the valuation. Lenders should also be cautious about allowing a Borrower a consent (or perhaps even consultation) right in relation to the identity of the valuer to be appointed;
- if local laws do provide for state-certified or state-licensed valuers, best practice would be to use a state-certified or state-licensed appointee, unless there are good reasons to the contrary; and
- market value should be calculated in accordance with the definition of the Red Book or Appraisal Guidelines, as appropriate. The tests appear similar albeit with different wording, so the best practice for a U.S.-regulated lender operating in Europe is to ensure that the credit team is comfortable that both tests have been complied with, particularly if current guidelines change.

Although there is nothing in the LMA form of REF documents inconsistent with compliance with both the Appraisal Regulations in the U.S. and/or the ECB Guidance, there is scope to revise the drafting (in the manner discussed above) to make it easier for lending institutions to demonstrate compliance.

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