

EXPOSURE DRAFT OF PROPOSED REVISED INTERNATIONAL VALUATION APPLICATION 2 - VALUATION FOR LENDING PURPOSES

(published June 2006)

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Comments should be submitted in writing so as to be received by **31 August 2006**.

All replies may be put on public record unless confidentiality is requested by the commentator. If commentators respond by fax or email, it would be helpful if they could send a copy of the response by post. Comments should preferably be sent by email to:

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Invitation to Comment

Comments are sought on any aspect of the Exposure Draft, particularly on the questions set out below.

Questions:

- 1 There appear to be considerable differences in the scope of valuation reports expected by different lenders around the World. Some just require validation of the asset and a valuation. Others expect considerably more detail, for example, on market trends, sustainability of value over the life of the loan, anticipated obsolescence, financial status of any tenants, comment on the loan to value ratio etc. IVSC believes that it is worthwhile promoting a common standard for valuing physical assets for security purposes, as this is by far the most common valuation task worldwide, especially in real estate markets. However, it recognizes that this has to be sufficiently broad to be applicable across a wide range of markets.
 - a) **Do you agree that IVSC should be promoting a standard for valuation for lending purposes?**
 - b) **Are there any generally recognized standards applicable for this purpose in the markets in which you operate. If so, please indicate whether they require significantly more or less detail to be provided in the valuation report compared to this draft.**

- 2 In para 5.6 the term “Market Value as if Complete” is recommended as a suitable term to distinguish the value of a proposed development project assuming it had already been completed, from the value of the property in its existing condition.

It has been suggested by some that if IVSC promotes this phrase it could lead to insufficiently precise information being conveyed to the lender as to the exact assumptions made by the valuer, e.g., whether “as if complete” merely assumes that physical construction has been completed, or whether it also assumes that the work is compliant with regulations, that construction guarantees are available to a purchaser, etc.

Do you support the promotion of the term “Market Value as if complete”, or do you believe it more appropriate to provide that valuers should provide explicit assumptions as to the status and condition of the property if it is to be valued on any other basis than its existing condition?

- 3 Reference is made in para 5.7 to “stabilised occupancy”,
Is this a term commonly used in the markets in which you operate, and if so what does the term convey to you?
- 4 6.5.1 states that owner-occupied property will normally be valued on the assumption that that property is transferred unencumbered by any occupancy. It goes on to say that this does not preclude the existing owner as part of the market, just that any special advantage attributable to the owner’s occupancy be disregarded. Supporters of this view argue that it reflects the circumstances under which the current owner would acquire the property in the current market, is particularly relevant if the lending is in support of a current or recent acquisition. A contrary view is that in order to establish the value of the underlying security it is necessary to assume that the existing owner is not part of the market as this is the more likely scenario in the event that the lender has to rely on the security.
- a) **Which approach do you prefer?**
b) **Do you consider that both are properly described as Market Value?**
- 5 6.6.1 states that in some States Valuers are directed to ignore leases between related or connected parties as the terms of such leases may be influenced by the relationship and may not be achievable in the open market.
Please comment on the treatment of such leases in your area and whether you agree that there should be a general exclusion for such agreements when the valuation is for lending purposes.
- 6 The draft refers in para 6.8 to “Specialised Trading Properties”. These are more fully discussed in GN 12. They comprise a category of properties that are normally valued, even when vacant, by reference to their trading potential. This approach is appropriate if a property is only suitable for a specific type of business, which means that its value is inextricably linked to the performance of that business. This suitability may arise from the physical design of the property, from statutory consents or licenses that are not freely available for other property, or a combination of both. The value of such property will be closely linked to the market’s view of its suitability for the trade and the anticipated profits that would be earned from ownership. Examples of this type of property include hotels, fuel stations, theatres, and certain types of restaurant. It has been suggested that the term “Specialised Trading Properties” is not one in widespread use around the World and that there is also potential confusion with Specialised Property, which is a distinct category for valuation purposes. IVSC is considering using a different term to describe property of this nature.
Is Specialised Trading Property a term that is in general usage for property of this genre within the markets in which you operate? If not, is there a term that you prefer?

- 7 In paragraph 6.12 the problem of forced sales is discussed. The draft concludes that once the assumption that the parties to the hypothetical sale described in the Market Value definition will act reasonably is removed, speculating on the effect of an unreasonable constraint on price is unrealistic unless the valuer has detailed knowledge of the reasons for the constraint and the overall circumstances of the sale.
- Do you agree that predicting the outcome of a forced sale when the circumstances that would cause the vendor to be under undue compulsion to sell is unrealistic? Do you believe that IVSC should actively discourage the use of terms such as “forced sale value” or derivations of the term?**
- 8 This draft includes a short section on Bank Solvency Ratios, the Basle II Accord and the role that the calculation of “Mortgage Lending Value” (MLV) can have in lender’s compliance with the Accord. It has been suggested that more detail on the relevance of valuation in the Accord and an illustration of how MLV is applied provide important background information for valuers working in the field of secured lending. Others feel that this is more appropriate as background information rather than as part of an International Valuation Application (IVA), especially as the application of the Basle provisions is through national law, and there are detailed variations in the application of the valuation requirements. It has been suggested that IVSC should publish a separate Technical Paper dealing with the relevant provisions of Basle II.
- Do you agree that IVSC should produce more detailed information for valuers on the implications of Basle II and, if so, do you think that this should be part of this IVA or published in a separate paper?**
- 9 **Do you have any other comments on the exposure draft?**

EXPOSURE DRAFT OF PROPOSED REVISED INTERNATIONAL VALUATION APPLICATION 2 - VALUATION FOR LENDING PURPOSES

IVA 2 – Valuation for Lending Purposes

Introduction

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1.0 Introduction

- 1.1 The objective of International Valuation Application 2 (IVA 2) is to provide a framework for valuations of assets that are to be offered or taken as loan security.
- 1.2 It is important that Valuers consistently apply accepted valuation principles within the scope of these standards, providing clear, independent and objective opinions that are relevant to the needs of valuation users.

2.0 Scope

- 2.1 This Application applies in all circumstances where valuations are required of assets that are, or are proposed to be, held as security for lending. The lending may be done by means of different vehicles, including *mortgages*, *debentures* or other forms of fixed or floating charge.

3.0 Definitions

International Valuation Standards Definitions

- 3.1 *Debenture*. A bond, note or certificate issued by a company or corporation as a receipt for money lent at a fixed rate of interest until the principal is repaid. Typically, debentures are long-term, unsecured obligations.
- 3.2 *Market Value*. The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion (IVS 1, para. 3.1).

- 3.3 *Mortgage*. A pledge of an interest in property as security or collateral for repayment of a loan with provision for redemption on repayment. In the event the borrower (mortgagor) defaults, the lender (mortgagee) has the power to recover the property pledged.
- 3.4 *Specialised Property*. A property that is rarely if ever sold in the market, except by way of sale of the business or entity of which it is part, due to uniqueness arising from its Specialised nature and design, its configuration, size, location, or otherwise.

European Union Legislation Definition

- 3.5 *Mortgage Lending Value*. The value of the property as determined by a prudent assessment of the future marketability of the property taking into account long term sustainable aspects of the property, the normal and local market conditions, and the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value. The mortgage lending value shall be documented in a clear and transparent manner. (Pursuant to the Basle II Accord, a European Union Capital Requirements Directive [EU CAD] is currently being drafted. The above definition is cited in the Council of the European Union, *Proposal for Directives of the European Parliament and of the Council*, 12890/05 Add. 4, Annex VIII, Section 1.5, paragraph 65. This definition has been agreed by 25 governments with the European Parliament. The definition has not yet been formally adopted, but adoption is anticipated imminently.)

4.0 Relationship to Accounting Standards

- 4.1 Valuations for lending purposes do not generally involve consideration of Accounting Standards. Although similar bases may be reported, the assumptions upon which the valuation is based may be very different.
- 4.2 By way of example, one of the underlying principles of many valuations for financial reporting is the assumption that the entity will continue as a going concern. However, this assumption would not be appropriate for most valuations undertaken for loan security. A lender needs to know the security represented by the asset in circumstances when repayment of the loan is in jeopardy. If a business was to encounter financial difficulty, a going concern could not be assumed. This has particular implications for specialised assets where the value of the secured property, separate from the business of which it forms part, may be strictly limited.

5.0 Application

To perform valuations that comply with this Application and Generally Accepted Valuation Principles (GAVP), Valuers shall adhere to all sections of the IVS Code of Conduct pertaining to Ethics, Competence, Disclosure, and Reporting (sections 4, 5, 6, and 7).

5.1 In performing valuations of property for lending purposes, Valuers will normally provide the *Market Value* of such property in accordance with these International Valuation Standards.

5.2 If for any reason the Valuer departs from the basis of *Market Value*, the departure shall be clearly set out and explained in the Valuation Report along with the identification and definition of the alternative basis or bases used and an explanation of the reasons for the departure. If there is a substantial difference between the *Market Value* of the property and the alternative value, this should be reported.

5.3 The basis for the Valuer's engagement shall be clearly set out in any reports to be used by third parties. All reports should be presented in a way that would not be considered by a reasonable person to be misleading. The valuation opinion shall be reported in accordance with IVS 3, Valuation Reporting.

5.4 In addition to fulfilling the requirements of IVS 3, Valuation Reports for secured lending of real property should normally include such of the following items, as are relevant:

- 5.4.1 comment on current activity and trends in the relevant market;**
- 5.4.2 comment on historic, current and anticipated future demand for the category of property in the locality;**
- 5.4.3 comment on the potential and likely demand for alternative uses;**
- 5.4.4 comment on both the current marketability of the property and if requested, the likelihood of its sustainability;**
- 5.4.5 comment on any impact of foreseeable events (at the date of valuation) on the value of the security;**
- 5.4.6 the valuation approach adopted, and a statement as to the degree on which the valuation reflects market-based evidence.**

5.5 Valuations for loan security frequently require valuations that assume a change in the current state or condition of the property, for example in situations where the lending is for development of a new building. These valuations will normally be provided on the assumption that the specified changes have already occurred by the valuation date, i.e., they are not projections of what the value might be at a future date when the changes are actually complete. The report must clearly set out the assumptions upon

- which each such valuation is made, and make it clear that the valuation is contingent on the specified change having been made.
- 5.6** For a proposed property development, a valuation may be required at the completion of the development. Such a valuation reflects the expectations and perceptions of market participants at the date of the valuation report, assuming the development was complete. Use of the term *Market Value* without a modifier in these circumstances can be misleading. The recommended phrase is *Market Value as if complete*.
- 5.7** Similarly, the *Market Value* may be required to be assessed on the assumption of *stabilised occupancy*. This should also reflect the expectations and perceptions of market participants as at the date of the report.
- 5.8** In certain States, there are specific legal or regulatory requirements for property valuations for lending purposes. Any departures from this Application because of such requirements should be clearly explained.
- 5.9** Many corporate and individual loans from banks and other financial institutions are secured by an interest in specific property assets. Valuers need to have an understanding of the requirements of such institutions, and possibly the structure of loan agreement terms and arrangements. Lenders will usually require that the terms of a loan be kept confidential, but this does not relieve the Valuer of the obligation to have a general understanding of the lending process.
- 5.10** The Valuer shall make such disclosures as are appropriate to a given engagement and shall meet the Standards for reporting discussed in IVS 3, Valuation Reporting, and in section 6.13 below.
- 6.0 Discussion**
- 6.1** The manner in which property would ordinarily trade in the market determines the applicability of the various approaches to assessing *Market Value*. When based upon market information, each approach is a comparative method. In each valuation situation one or more methods may be applied. The Valuer will consider each method to determine which method(s) is/are most appropriate.
- 6.2** All *Market Value* measurement methods, techniques, and procedures will, if applicable and if appropriately and correctly applied, lead to a common expression of *Market Value* when based on market-derived criteria. All valuation methods should be based on market observations. Construction costs and depreciation should be determined by reference to an analysis of market-based estimates of costs and accumulated depreciation. The *Income capitalisation approach* or *discounted cash flow analysis* (DCF) should be based on market-determined cash flows and market-derived rates of return.

6.3 Valuers may receive requests for valuations for lending purposes on an alternative basis to *Market Value*. IVS 2 addresses the types, use and reporting of some common alternative bases of valuation. The Valuer should ensure that an alternative basis is not confused with *Market Value*. Although there may be circumstances where an alternative basis is appropriate for secured lending, users of such valuations should be made aware that such values may not be realisable in the market.

6.4 *Investment Properties*

6.4.1 Income-producing properties are usually valued individually, but lending institutions may wish to know the value of a property as part of a portfolio of properties. In such instances, the distinction between the value of the individual property, assuming it is sold individually, and its value as part of the portfolio should be clearly expressed.

6.4.2 Lenders may require the Valuer's opinion as to the security of the debt service on a loan, or the ability of the property to meet interest payments and repayment of principal (where appropriate) over the term of the loan. This may be outside the area of expertise of the individual Valuer.

6.5 *Owner-Occupied Properties*

6.5.1 Owner-occupied properties valued for loan security purposes will normally be valued on the assumption that the property is transferred unencumbered by any occupancy, and that the buyer is entitled to full legal control and possession. This does not preclude consideration of the existing owner as part of the market, but it does require that any special advantage attributable to the owner's occupancy, which may be reflected in a valuation of the business, be excluded from the valuation. If the Valuer is required to address a different basis of valuation, the Valuation Report should also refer to the value derived from market evidence of vacant possession sales of similar properties.

6.6 *Leases Between Related or Connected Parties*

6.6.1 In some States, Valuers are directed to ignore leases between related or connected parties as the terms of such leases may be influenced by the relationship and may not be achievable in the open market.

6.7 *Specialised Properties*

6.7.1 Specialised properties by definition may have limited marketability and generally only have significant value as part of a business (see General Valuation Concepts and Principles, para. 8.2). For loan security purposes,

the only value that a lender should rely upon is the value for any alternative use that is reasonably foreseeable, after due regard is given to the costs and risks that would be involved in achieving that use. Many lenders would not consider a specialised property to be suitable as a specific security for lending purposes.

6.7.2 Valuers may be requested to provide a valuation of a specialised property, which is part of a going-concern business for loan security. Although the property may be in the process of being transferred as a going concern and the Valuer might be asked to comment on the value under that assumption, the lender should be alerted to the dependence of this valuation on the continuing profitability (or otherwise) of the going concern. If the value for any alternative use would potentially be lower, this should be drawn to the attention of the lender.

6.8 *Specialised Trading Property* (also see GN 12)

6.8.1 Certain classes of property, including but not limited to hotels and other trading businesses, are usually valued, based on an assessment of future maintainable profits, excluding any special goodwill derived from an operator with above average management skills. In such cases, the lender should be made aware of the significant difference in value that may exist between an operating concern and a non-operating concern where the business is closed, the inventory is removed, licences (and other intangible assets such as certificates, franchise agreements, or permits) are removed or are in jeopardy, and other circumstances exist that may impair future operating performance.

6.8.2 The Valuer may also provide suitably qualified advice as to potential future fluctuations in the status of the property as security. For example, if the income from a property is critically dependent on a tenant or tenants from a single industry, or some other factor could cause future income instability, the Valuer should address these factors in the Valuation Report. In certain cases, an assessment of the value of the property for alternative use, assuming vacant possession, may be appropriate.

6.9 *Development Properties*

6.9.1 Properties held for redevelopment or sites intended for development of non-specialised buildings should be valued with consideration given to existing and potential development entitlements and controls. Any assumptions as to planning issues and other material factors must be reasonable, validated by market behavior and explicitly stated in the Valuation Report.

- 6.9.2 The phasing and timing of funding in a lending agreement should be discussed with the lender, and periodic valuations may be required over the development cycle.
- 6.9.3 The approach to the valuation of development properties will depend on the state of development of the property at the date of valuation and the degree to which the development is pre-sold or pre-leased. The method the Valuer selects may need to be discussed with the lender prior to undertaking the valuation. Care should be taken by the Valuer to:
 - 6.9.3.1 make a reasoned estimate of the development period from the date of valuation. The effect of additional development requirements on costs and revenues, using present value discounting where appropriate, will be reflected in this analysis;
 - 6.9.3.2 anticipate as far as is possible at the date of valuation, market changes during the remaining period of the development;
 - 6.9.3.3 consider and indicate the risks associated with the development; and consider and disclose any known special relationships between the parties involved in the development.

6.10 *Wasting Assets*

- 6.10.1 Lending issues arise in relation to the valuation of wasting assets such as mines or quarries. The lender's attention needs to be drawn to the risk associated with this type of a wasting asset and the planned program for its extraction or use.
- 6.10.2 A property rental that exceeds the market or economic rent may constitute a wasting asset because any value attributable to this factor diminishes as the term of the lease decreases.

6.11 *The Valuer*

- 6.11.1 The nature and scope of the engagement should be clear and well understood by the Valuer and by the user of the Valuer's services. Valuers should be aware of the risk associated with valuations for lending purposes where misunderstanding and/or error may lead to a dispute or even litigation between the lender and the Valuer. For example, in the event of default by a borrower, the lender may sell a property after foreclosure and realise less than the valuation.
- 6.11.2 In some jurisdictions financial services legislation requires special licensing or registration of advisers when advice is related not only to the value of property, but also to securities issues such as equity, participatory interests, collective investment schemes, or syndicated loans. Valuers may be restricted in the advice they can provide in these jurisdictions.

6.11.3 Because of the special circumstances involved with most loan security and mortgage arrangements, it is particularly important that the Valuer be independent of the borrower. It is also important that the Valuer possess appropriate experience with the particular property type and locale for the property involved, or else seek expert assistance.

6.12 *Forced Sales and Limited Marketing or Disposal Periods*

6.12.1 Lending institutions may request valuations on a forced, or liquidation, sale basis or impose a time limit for disposal of the security. If this time limit is insufficient to allow for proper marketing then such valuations would not meet the definition of *Market Value*. Because the impact of an unreasonable constraint on the price obtainable will depend upon the exact circumstances under which the sale takes place, it is not realistic for the Valuer to speculate on a price that could be obtained without either knowledge of the reasons for the constraint or the circumstances under which the property might be offered for sale. An alternative to *Market Value* may be provided on the basis of a set of defined assumptions, but the Valuer should draw the lender's attention to the fact that this opinion is only valid at the valuation date, and may not be relied upon in the event of a future default, when both market conditions and the sale circumstances may be completely different.

6.13 *Lenders' Solvency Ratios*

6.13.1 Major banks and other lenders are normally subject to regulations that limit the total amount they can lend as a proportion of the lenders' assets, known as the *solvency ratio*. In the international context, the Basle II Accord sets out rules for the minimum solvency ratios to be maintained by lending institutions and how those ratios are to be calculated. The value of assets over which the lender holds security is used in calculating the solvency ratio.

6.13.2 The Basle II Accord provides that two valuation approaches may be considered in assessing the value of security represented by commercial real estate. The first of these is the *Market Value* of the secured assets. The proportion of a loan secured that is below 50% of the *Market Value* carries a lower risk weighting. The second valuation approach is *Mortgage Lending Value* (MLV). Because by definition, MLV is a more conservative figure than *Market Value*, the lower risk weighting applies to the proportion of the loan below 60% of the *Mortgage Lending Value*.

6.13.3 *Mortgage Lending Value* is a long-term, risk assessment technique. As such, it is not a basis of value, i.e., it is not an estimate of the value, based on assumed conditions at a specific date. It is a technique that is primarily

used by banks in a number of European countries. Addendum A provides an explanatory paper prepared by the European Mortgage Federation.

7.0 Disclosure Requirements

7.1 Valuers should take all steps to ensure that reports are not misleading or capable of misinterpretation and that their observations, findings and conclusions are clearly expressed. In general, reports prepared in accordance with IVA 2 will meet the reporting requirements discussed in IVS 1, Market Value Basis of Valuation, and IVS 3, Valuation Reporting. Reports should contain a specific reference to the definition of *Market Value* together with a reference to the *highest and best use* of the property.

7.2 Such valuations should also refer to the specific date of valuation, the purpose and function of the valuation, and such other relevant and appropriate information to ensure adequate and reasonable interpretation of the Valuer's findings, opinions, and conclusions.

7.3 In reporting *Market Value* for loan security purposes, the Valuer shall make all disclosures required under IVS 3, Valuation Reporting.

8.0 Departure Provisions

8.1 In following this Application any departures must be in accordance with directions provided in IVS 3, Valuation Reporting.

9.0 Effective Date

9.1 This International Valuation Application became effective XXX.

**EXPOSURE DRAFT OF PROPOSED REVISED INTERNATIONAL VALUATION
APPLICATION 2 - VALUATION FOR LENDING PURPOSES (published June 2006)**

ADDENDUM A

European Mortgage Federation paper on Mortgage Lending Value

This explanatory note has been prepared by the European Mortgage Federation and is provided for information only. IVSC has no responsibility for its contents and it does not form part of the valuation application.

- (1) Mortgage Lending Value may be used by the financial services industry in the activity of lending secured by real estate. The Mortgage Lending Value provides a long-term sustainable value limit, which guides internal banking decisions in the credit decision process (e.g. loan-to-value, amortization structure, loan duration) or in risk management.

Mortgage Lending Value facilitates the assessment of whether a mortgaged property provides sufficient collateral to secure a loan over a long period. Given that Mortgage Lending Value is intended to estimate property value for a long period of time, it cannot be grouped together with other valuation approaches used to estimate market value on a fixed date.

- (2) Additionally, Mortgage Lending Value can be used as a risk management instrument in a number of ways in the context of
 - capital requirements for credit institutions as detailed in Basel I and II
 - funding of mortgage loans through covered bonds secured by real estate as the cover assets
 - the development of capital market products converting real estate and real estate collateral into tradable assets (e.g. mortgage backed securities)

The concept of Mortgage Lending Value is defined in detail by legislation, Directives and additional country specific regulation.

- (3) Mortgage Lending Value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account the long term sustainable aspects of the property, the normal and local market conditions, as well as the current use and alternative possible uses of the property. Speculative elements should not be taken into account in the assessment of Mortgage Lending Value. Mortgage Lending Value should be documented in a clear and transparent way.

All internationally recognised valuation methods also apply to the Mortgage Lending Value, subject to the type of property and the market specificities (historic, legal etc.) where the property is located. These are re:

- comparison method
- income method
- depreciated replacement cost method

(4) Regarding the technical transposition of the definition mentioned above, the long term validity of Mortgage Lending Value requires compliance with a certain number of steps aimed at eliminating short term market volatility or temporary market trends.

The valuer must address the following key issues when determining the Mortgage Lending Value of a property:

- The future marketability and saleability of the property has to be assessed carefully and prudently. The underlying time perspective goes beyond the short term market and covers a long term period.
- As a principle, the long term sustainable aspects of the property such as the quality of the location, construction and allocation of areas must be taken into account.
- As far as the sustainable yield to be applied is concerned, the rental income must be calculated based on past and current long term market trends. Any uncertain elements of possible future yield increases should not be taken into account.
- The application of capitalisation rates is also based on long term market trends and excludes all short term expectations regarding the return on investment
- The valuer must apply minimum depreciation rates for administration costs and capitalisation of rents.
- If the mortgage lending value is derived using comparison values or depreciated replacement costs, the sustainability of the comparative values needs to be taken into account through the application of appropriate discounts where necessary.
- The mortgage lending value is generally based on the current use of the property. The Mortgage Lending Value shall only be calculated on the basis of a better alternative use, under certain circumstances i.e. if there is a proven intention to renovate or change the use of the property.
- Further requirements, for example with respect to compliance with national standards, transparency, content and comprehensibility of the valuation, complement the legal framework for the calculation of Mortgage Lending Value.

(5) There are a number of clear differences between Market Value and Mortgage Lending Value; Market Value is internationally recognised for the assessment of the value of a property at a given moment in time. It estimates the price that could be obtained for a

property at the date of valuation, notwithstanding that this value could alter very rapidly and no longer be up-to-date.

In contrast, the purpose of Mortgage Lending Value is to provide a long term sustainable value, which evaluates the suitability of a property as a security for a mortgage loan independently from future market fluctuations and on a more stable basis. It provides a figure, usually below Market Value and therefore able to absorb short term market fluctuations whilst at the same time accurately reflecting the underlying long term trend in the market.

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