



## **IVSC Information Paper**

### **Implementation of Basel II in the EU (CRD) / Property Valuation**

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#### **Worldwide implementation of Basel II**

The Basel Committee has no legislative authority. Therefore, the framework agreement on "International Convergence of Capital Measurement and Capital Standards" passed by the Basel Committee in June 2004 and popularly known as Basel II is not legally binding. Basel II is only directly relevant for internationally operating banks that have voluntarily agreed to be bound by a so-called 'Gentlemen's Agreement'.

The national regulatory authorities represented on the Basel Committee recommend the acceptance of Basel II in their countries as a framework for more far-reaching national regulations. Corresponding national implementations are carried out on a voluntary basis and in varying forms. Voluntary worldwide implementation of the regulations that goes beyond the national level is widely desired. To what extent this will ultimately be realised remains to be seen.

On the level of the European Union (EU), a legally binding implementation has been put through in the form of a directive.

#### **Implementation of Basel II in the EU**

Concurrent with the work of the Basel Committee, the EU drafted a legal instrument for implementing the Basel II framework agreement. The aim here was to formulate general EU regulations for capital standards in harmony with Basel II, while taking into consideration the specific conditions prevailing in the EU.

The new EU directive (Document 12890/05 of 18th October 2005), which is based on the directive proposal (COM(2004)486) issued by the European Commission on 14th July 2004, was approved by the European Parliament on 28th September 2005 and by the Council on 11th October 2005. It is known as "CRD" ("Capital Requirements Directive")<sup>1</sup> and forms the legally binding framework for national regulatory legislation for all credit institutions and securities issuers in the EU Member States. The Member States are obligated to implement the CRD as part of their national law.

In line with the planned worldwide introduction of Basel II, the new regulations should be applied starting at the beginning of 2007 and the refined approaches starting in 2008.

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<sup>1</sup> The exact name of the document is: "DIRECTIVES OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL Re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions."

## Structure of the CRD

The CRD comprises two newly drafted directives, each of which is made up of articles with fixed principles and aims and annexes with detailed individual technical provisions.

In order to ensure that the directive is adaptable to market developments, modification options are provided for in the case of the individual technical provisions.

## A comparison of Basel II and CRD

The principles of Basel II are retained in the CRD.

Analogous to Basel II, the CRD offers three approaches to capital measurement that differ in the level of demands they place on those applying them:

- Standardised Approach
- IRB Approach in two forms with varying complexity

The content of the approaches largely corresponds with Basel II, although individual provisions may vary.

The regulations relevant to property valuation are found in the first part of the CRD (Recast Directive 2000/12/EC) in the subsections and annexes for the **Standardised Approach**, for the **IRB Approach** and for **Credit risk mitigation**.

### Standardised Approach (articles 78-83, annex VI)

Capital measurement is carried out according to general risk weight classes. All exposures are divided into 16 exposure classes.

Real estate collateral types are relevant in the exposure classes "retail claims", "claims [...] secured on real estate property" and "claims in the form of covered bonds".

Exposures fully and completely secured by mortgages on properties can under certain circumstances receive more favourable risk weights (instead of 100% risk weight):

- 35% risk weight for exposures "fully and completely secured [...] by mortgages on residential property which is or shall be occupied or let by the owner or the beneficial owner in the case of personal investment companies"

The rules state that "the value of the property exceeds by a substantial margin the exposures".

- 50% risk weight for exposures "fully and completely secured [...] by mortgages on offices or other commercial premises"

The 50% risk weight shall apply to that part of the loan that does not exceed 50% of the market value or 60% of the mortgage lending value of the property. The part of the loan that exceeds the limits receives a 100% risk weight.

There are ceilings for mortgages that can be recognised for securing covered bonds using real estate. The ceilings relate to "the value of the pledged properties".

In order to claim the more favourable risk weight and in connection with covered bonds, "minimum requirements" and "valuation rules" must be observed (see under "Credit risk mitigation").

By contrast with the IRB Approach, mortgages are not recognised as collateral in connection with credit risk mitigation under the Standardised Approach.

### Internal Ratings-Based Approach (IRB Approach) (articles 84-89, annex VII)

In the IRB Approach capital measurement is not generalised into classes. Analogous to Basel II, the required capital is calculated according to risk-weight functions.

The necessary calculation parameters are identified as follows in the CRD:

- PD probability of default

## Implementation of Basel II in the EU (CRD) / Property Valuation

- LGD loss given default
- M maturity
- exposure value

In the IRB Approach provided for in the CRD there are seven exposure classes. As in Basel II, real estate collaterals are relevant in the exposure classes "claims on corporates" and "retail claims".

In accordance with Basel II, there are two IRB Approaches of varying complexity to choose from for the "corporate" claims class. The difference is whether the credit institution calculates only the PD by itself or also the LGD. In the case of "retail claims", the CRD does not distinguish between the approaches, i.e. PD and LGD must always be estimated by the credit institution itself. For the parameters that the banks themselves do not calculate, differentiated standard values are specified. Credit institutions can make use of values from a data pool for their own estimate of risk parameters. This is designed to make it possible for even smaller credit institutions to use the more risk-sensitive approach.

If the IRB Approaches are to be applied, express permission must be obtained and certain minimum requirements must be observed, along with disclosure, documentation and validation regulations.

When applying the IRB Approach, real estate collaterals used in capital measurement can under certain circumstances be recognised for credit risk mitigation. Eligible real estate collaterals are:

- "Residential real estate property which is or shall be occupied or let by the owner or the beneficial owner in the case of personal investment companies"
- "Commercial real estate i.e. offices and other commercial premises."

### **Credit risk mitigation** (articles 90-93, annex VIII)

This subsection comprises "**minimum requirements** for the recognition of real estate collateral" (annex VIII, part 2, paragraph 8) and "**valuation rules** for real estate collaterals (annex VIII, part 3, paragraphs 63 - 66). The minimum requirements and valuation rules apply when using either the Standardised Approach or the IRB Approach.

#### **Minimum requirements** are:

- "Legal certainty"

The collateral must be realisable within an appropriate period of time.

- "Monitoring of property values"

The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every three years for residential real estate.

More frequent monitoring shall be carried out where the market is subject to significant changes in conditions.

Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation.

The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices.

For loans exceeding EUR 3 million or 5% of the credit institution's own funds, the property valuation shall be reviewed by an independent valuer at least every three years."

'Independent valuer' shall mean a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process."

- Documentation duties
- "Insurance"

The credit institution shall have procedures to monitor that the property taken as protection is adequately insured against damage."

#### The **valuation rules** demand that:

- "The property shall be valued by an independent valuer at or less than the market value.

In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions, the property may instead be valued by an independent valuer at or less than the mortgage lending value."

## Implementation of Basel II in the EU (CRD) / Property Valuation

- Market value definition:

"Market value means the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.[<sup>2</sup>] The market value shall be documented in a transparent and clear manner"

- Mortgage lending value definition:

"Mortgage lending value means 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, 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 transparent and clear manner."<sup>3</sup>

- "The value of the collateral shall be the **market value or mortgage lending value** reduced as appropriate to reflect the results of the monitoring [...] and to take account of any prior claims of the property."

### **Real estate valuation process in connection with the CRD compared to Basel II**

In comparison with Basel II, the CRD offers a less strict alternative for residential real estate in terms of the regular monitoring generally required for all real estate collaterals. This monitoring must not take place annually, but only every three years.

Furthermore, Basel II and CRD differ in two major points:

- Valuation review

For loans exceeding EUR 3 million or 5% of the credit institution's own funds, the property valuation shall be reviewed by an independent valuer at least every three years." - Basel II does not specify this requirement. On the other hand, "a credit event, such as a default", which according to Basel II calls for a valuation review, is not mentioned in this context.

- Significance of mortgage lending value

Apart from the market value, the mortgage lending value, a concept that plays an important role in the credit business of various European countries, is also quite significant.

In EU Member States in which rigorous criteria apply for the assessment of the mortgage lending value, market value and mortgage lending value are given equal weight for the valuation of real estate collaterals. – Under Basel II by contrast, the rules for valuing real estate collaterals relate only to market value.

The ceilings for the more favourable risk weight for commercial properties under the Standardised Approach, as well as for loss-rates (as proof of well-developed and long-established real estate markets) in the Standardised and IRB Approaches are based on the market value and, if applicable, on the mortgage lending value as well. – Under Basel II, only the exemption for the more favourable risk weight for commercial properties in the Standardised Approach is based on the market value and the mortgage lending value.

### **The real estate valuation processes described in the paper on "Basel II / Property Valuation" of 20th April 2006 also fulfil the valuation requirements of the CRD.**

At this time, the national implementation of the CRD is the responsibility of the EU Member States.

The CRD is implemented in England, for example, by applying the BIPRU ("Prudential sourcebook for banks, building societies and investment firms"), part of the FSA Handbook.

The implementation of the CRD in German bank supervisory law is to go into effect as of 1st January 2007 and includes an amendment to the Banking Act (Kreditwesengesetz – KWG), the enactment of a Solvency

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<sup>2</sup> Corresponds with the IVSC definition.

<sup>3</sup> Similar to the IVSC definition.

Implementation of Basel II in the EU (CRD) / Property Valuation

Regulation (Solvabilitätsverordnung – SolvV) to establish the rules for capital requirements, as well as a new version of the regulation governing large exposures (Großkredit- und Millionenkreditverordnung – GroMikV).