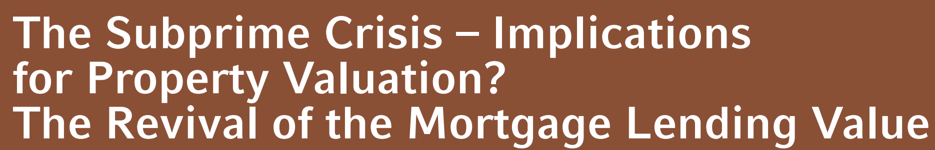

The Subprime Crisis – Implications for Property Valuation? The Revival of the Mortgage Lending Value

The continuing crisis in the financial markets has its origin in property lending and particularly in the practice of financing long-term investment assets such as property based on Market Values which are valid only at a given date. This article highlights the advantages of using the Mortgage Lending Value for property finance and – through the evening out of peaks and troughs – for property markets in general.

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1 The Global Property Market

Judging by press reports and the opinions of market players, certain property markets and sectors have experienced value reductions of up to 30 % and more in the last year. Additionally, the number of transactions has fallen sharply and significant increases in property yields have been reported. This is surprising only in as far as the reason for the correction of the strong property price increases experienced in recent years was not as usual economic recession but the current crisis in the financial markets. Anyone who had followed the markets diligently knew that they had reached an all time peak and were showing signs of excess. Some players spoke of a "yield compression", characterised by the recently experienced boom phase, whereby prices rose in spite of rental increases being unforeseeable. This was also the case in the German market where increases were not as marked as, for example, those in the anglo-american markets. In Britain towards the end of the boom, annual net initial yields for retail warehouse parks of less than 5 % were recorded – as opposed to over 7 % a few years earlier. In the United States also, in the three years preceding the end of the boom, Cap Rates* in many market sectors fell by more than 300 basis points (i.e. 3 % p. a.). There are many explanations for the strong property demand which led to these market movements. It is certain that while it may not have been triggered by the huge increase in the availability of funding at low rates of interest, it was definitely assisted by it.

Typical of the current crisis was the complete reliance upon the Market Value for the purpose of property valuation. Annual revaluations determining ever higher Market Values led to a sense of euphoria and to a further strengthening of the price spiral and not to a gentle braking to a realistic level. There was often no value benchmark showing how far current estimates of the Market Value had diverged from those values originating in the pre-boom phase. The risk potential resulting from market developments alone was no longer discernable, in particular in the case of new investment acquisitions. In such cases, the experience of property professionals is crucial, assisted by an experienced risk management team, to get the measure of market excesses and to implement the necessary precautionary measures.

2 Market Value

The Market Value is a method of determining the value of a property that is calculated solely as at a specific date and only providing an opinion of value relevant at this particular point in time. It reflects future developments only in as much as these are reasonably foreseeable by a typical investor according to the definition of the Market Value. Speculative elements can also be taken into account if these are commonly reflected by current market aspirations. Future rental increases which may be anticipated on lease expiry are also included as being sustainable in this approach. Additionally, short-term peaks in market demand, discernable at the time of the valuation may also be reflected in the Market Value, if they have a bearing on a property's value at the relevant date. The Market Value serves above all as an indication of sale price and should therefore only have validity for this purpose and for a limited marketing period.

*Proportion purchase price to gross income

Hence, for example, the Market Value of a residential apartment complex (condominiums) in the USA in a peak market phase can be estimated at ca. 230 million Dollars. As a result of the crisis in the property market, two years later, the same valuer reported a figure of only 60 million dollars. Both Market Values were deemed appropriate at their respective points in time. The current high levels of uncertainty in the British property market have resulted in certain instances in valuers referring to the so called "Guidance note 5" of the RICS (Royal Institution of Chartered Surveyors) Red Book. This provision enables valuers, in special circumstances, to no longer be responsible for the accuracy of values reported. This exclusion has led to banks refusing to grant finance for projects or only subject to onerous conditions. Such uncertainty and volatility surrounding the Market Value means that neither property investors nor banks can pursue a longer term risk and asset-monitoring strategy.

The Market Value Combined with other Elements of Risk Management

Until recently, the Market Value was the only element that clients, in particular in anglo-saxon markets, asked of their valuers. How the client interpreted the results of a valuation report was no longer the responsibility of the valuer and was immaterial to the client's own requirements as to value.

As most market players were aware that a Market Value was only valid at a specific date, investors or banks would make additions or deductions as they deemed appropriate depending upon the purpose of the loan and anticipated risk and taking into account the relevant time period. The considerable volatility of the Market Value, coupled at the same time with much pressure to plan for the long term, led in the recent past to the development of ever more new models for calculating a "secure value" that was as long-term and sustainable as possible. This "secure value" was nevertheless dependent upon the purpose of the loan, its term and where possible upon macro-economic factors. As the bank often was neither acquainted in detail with the property nor had access to comparable market data of the same quality as that available to the valuer, factors such as local market conditions or property related risks which manifest themselves particularly over the longer term, played no part in their judgement as to value. Until the current crisis broke, the Market Value alone appeared to be the yardstick against which risk management strategy, loan allocation and also the deal monitoring process that followed were determined.

The Financial Crisis and Accounting Standards

The current crisis in the financial markets has clearly proven to the banking sector what effects short-term valuations of market prices can have. In accordance with International Accounting Standards (IAS) the valuation of various assets, including financial products has to reflect the so-called Fair Value. Under conditions of extreme volatility or where for a temporary period market prices cannot be assessed, IAS rules stipulate that immediate and in some cases substantial write-downs have to be made. It therefore comes as no surprise that now, in order to achieve a cushioning of volatility in the accounts and in order not to exacerbate the problem by pro-cyclical accounting, many financial sector operators are demanding a return to the old depreciation procedures e.g. laid down in Germany's Commercial Act (Handelsgesetzbuch, HGB).

The property market with all its oscillations is subject to similar functions in an IAS context. In accordance with the IAS, organisations involved with property are obliged to make ongoing adjustments in line with the market, and these are painful when changes are negative. A valuation tool which, in times of volatile property prices, would make possible a sustainable view of asset values would lead to a smoothing of market fluctuations. In a boom phase, excesses could be recognised and could be incorporated in a satisfactory risk management strategy, and in times of depression would have much more moderate consequences.

The property lending activities of international banks in volatile markets often intensify the current market cycle. In most cases, loan volumes and also subsequent covenants in the loan agreement make reference to the relevant Market Value. Hence, depending upon the risk awareness of the bank, a corresponding loan-to-value covenant as at a specific date or an upper limit covenant over the term of the loan will be offered. Both covenants are for the most part not geared towards current and certainly not towards future market conditions and asset quality, but often depend upon the bank's own risk criteria and can also be affected by market pressures banks are subject to. Specialist knowledge of the subject property or the relevant market sector is not necessarily a prerequisite for the drafting of credit terms. Often, these terms are not drawn up by a property specialist who has inspected the site and analysed it as would a valuer, thus being able to compare it with similar assets in the sector.

Pro-Cyclical Effects of Margin Obligations

In rising markets, the very pronounced correlation between the Market Value and loan amount leads virtually automatically to increases in loan volumes. In rapidly falling markets on the other hand covenants based on the Market Value are breached very quickly. The interdependence of the volume of loans outstanding with the Market Value results in a pro-cyclical behaviour among all financial institutions, which accelerates market trends and puts property owners under firm pressure in a recessive phase. During a property crisis with volatile markets, credit terms based on the Market Value become burdensome. When a covenant concerning the obligation to maintain a permanent gap between the Market Value and loan amount is breached (so-called event of default), which at the start of a recession can occur in less than half a year from the payout of the loan, an investor must, for example, provide additional equity. As a one-off event, this is certainly not critical. A fall in prices throughout the entire property sector – the norm in a property crisis – then has various pro-cyclical consequences: a property holding company could find itself obliged to come up with more equity in respect of several of its holdings or on several occasions in respect of one or several properties. This greatly increases the risk to the lending bank that its debtors can no longer fulfil their contractual obligations.

It is clear that a Market Value determined as at a specific date is insufficient for longer term loan monitoring, and that a different valuation model is necessary to enable a sustainable prognosis to be made.

3 Discussions and Concepts as to a "Secure Value"

It is highly desirable that the valuer comments upon a property's longer term value sustainability. This "secure value" can be seen as a benchmark wherefrom it is evident that the market is currently in a boom phase if there is a substantial difference between this value and the Market Value. Likewise in a recession, the benchmark and the Market Value can work out to be approximately equal. There are several approaches to determining such a "secure value".

Deduction Method

A recurring solution to the problem of finding a "secure value" is the so-called deduction method. In this case, depending upon the type of property or location, the valuer should make a standard or fixed percentage deduction from the Market Value as calculated. A deduction by a fixed percentage amount, however, cannot serve as a benchmark, as the individual qualities of the property are not considered and further, the fact that the market is in a boom or bust phase is not taken into account. A deduction by a variable percentage may result in a secure value but only gets you halfway there, as the method has to combine all risks in a single percentage value and there is a lack of transparency. An easier method to follow and simpler for the valuer to calculate would be a method addressing normal valuation parameters adopting deductions which adequately account for the features of the property, risks or are bound within upper or lower limits, factors which are addressed, for example, in the principles of the Mortgage Lending Value.

Vacant Possession Value (VPV)

Due to significant cooling particularly of the commercial property market in the UK, anglo-saxon valuers have for some time now started to determine a Vacant Possession Value in addition to the Market Value. This is an attempt to come up with a secure value within the framework of normal anglo-saxon valuation procedure in times of crisis. This value is based upon the assumption that as at the valuation date, the property is vacant and available to let to an average tenant currently present in the market on average rental terms. In this case, the practice in anglo-saxon valuations of typically reflecting the quality of the current tenants' covenant is disregarded and the result is definitely one which also disregards both particularly high rents stemming from a previous market peak and any landlord-friendly lease terms. Thus in terms of sustainabilty and marketability of the property, this method is closer to the Mortgage Lending Value. It does not, however, amount to a secure value, as in a boom phase the method results in an over-valuation. At times when the market is emerging from a recession, properties are normally let at very low rents on tenant-friendly terms. In this case, for VPV, the higher market rents are adopted but as these rents are nevertheless not immediately achievable the VPV lies above the Market Value, making it appear over-optimistic.

4 The Mortgage Lending Value

History and Function of the Mortgage Lending Value

For more than 100 years, property finance in Germany has known a method of determining a secure value. This goes back to the time-honoured Mortgage Bank Act (Hypothekenbankgesetz) dating from 1900, which was replaced in 2005 by the Pfandbrief Act (Pfandbriefgesetz). In order to comprehensively protect investors in Mortgage Pfandbriefe, the Mortgage Lending Value was defined as the value a property would achieve at any time during the period of the loan, in a sale at arm's length in the open market without force or coercion. In order to calculate this particular value, originally called a value at the time of sale, special procedures were defined, and these were most recently consolidated in the Regulation on the Determination of the Mortgage Lending Value (Beleihungswertermittlungsverordnung, BelWertV) of 2006.

The Mortgage Lending Value

Under § 3 of the Regulation on the Determination of the Mortgage Lending Value (BelWertV), the Mortgage Lending Value is the value of the property which based on experience may throughout the life of the lending be expected to be generated in the event of sale, unattached by temporary, e.g. economically induced, fluctuations in value on the relevant property market and excluding speculative elements.
Further, the future marketability of the property is to be taken as a basis within the scope of a prudent valuation, by 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.

The substantial increases in cash volumes in the capital markets mentioned earlier resulted among other things in banks being increasingly able to refinance more cheaply through securitisation since the mid 1990s. At the same time, the differential to refinancing through unsecured debt in the capital markets became so small that it did not justify the effort which the Mortgage Bank Act and later the Pfandbrief Act demanded, e.g. the need to keep a mortgage register. As a result of waning importance of the Pfandbrief sector, it appeared at the time that the Mortgage Lending Value was losing ground also.

Even the introduction of new equity rules for banks (Basel II), which offered substantial easings in the permanent monitoring of loans if a Mortgage Lending Value had been calculated, couldn't reverse this trend. Not least the criticism that the methodology prescribed in the BelWertV led to values ever further removed from the market, had contributed to the fact that the Mortgage Lending Value received little actual recognition among valuation circles outside of banks.

The current crisis has resulted in institutions in property finance finding it much more difficult to obtain refinancing, and in some cases this is ongoing. For banks, some refinancing channels have been closed for months and for others they are having to pay considerably higher rates to obtain funds. The Mortgage Pfandbrief affords the only refinancing possibility for property finance available in the current crisis at an acceptable price. Along with the stringent regulations governing Pfandbriefe, investors mention above all the Mortgage Lending Value as an important plus factor. Due to this new attractiveness, there has been a proliferation of enquiries in the last few months as to how refinancing through Pfandbriefe can be achieved. It is remarkable that these enquiries are no longer coming from German banks only. Foreign financial institutions and countries (such as the US), which in the past found the rules too onerous and the concept too removed from the market are discovering the Pfandbrief system and – as an important element of it – the Mortgage Lending Value.

Apparently it has taken the current crisis to show market players that longer-term considerations and the particular security characteristics of property do not go together with a value calculated at a specific date.

The Mortgage Lending Value incorporated in Loan Terms

As a result of its longer-term basis, loan agreements made on the basis of the Mortgage Lending Value can absorb the largest of market fluctuations. Firstly, covenants tied to the conservatively calculated Mortgage Lending Value trigger cases of default much less frequently than those based on the Market Value. Secondly, due to the differential between the Market Value and the Mortgage Lending Value, the point in the market cycle at which the property finds itself becomes more transparent. In volatile markets in particular, the Mortgage Lending Value assumes a smoothing role, ensuring that exaggerations in both directions are evened out and do not directly affect the actions of market players. It also mirrors the nature of property investment as long-term. Property can lose value considerably due to market fluctuations. A stable cash flow over the fixed period of a lease, however, can also mean that the financing for the particular property may be able to ride out difficulty, possibly holding out through a property crisis without causing a loss for the bank.

The Mortgage Lending Value does not mean Crystal Ball Gazing

One often hears market professionals and valuers remark that calculating the Mortgage Lending Value involves gazing into crystal balls. Naturally, it is difficult to look into the future and relying on current comparable market data is certainly easier for a valuer than thinking about the possible future situation in respect of the property. However, the question must be put as to how valuers using DCF models come up with their detailed calculations for a period of 10 to 20 years. The Investment method of valuation is also based upon the assumption that income is sustainable in the future and the yield is in line with that assumption. Obviously valuers are perfectly able to and comfortable with making judgements about the future. With the Mortgage Lending Value, however, the valuer is required to meet a further challenge: He or she must also be acquainted with the property market in the past in order to be able to assess the risk factors which might befall the property in the future. For this, access to a comprehensive database and sufficiently long market experience is necessary. Anyone who is lacking in these areas certainly feels a degree of insecurity and reluctance towards the Mortgage Lending Value as a concept.

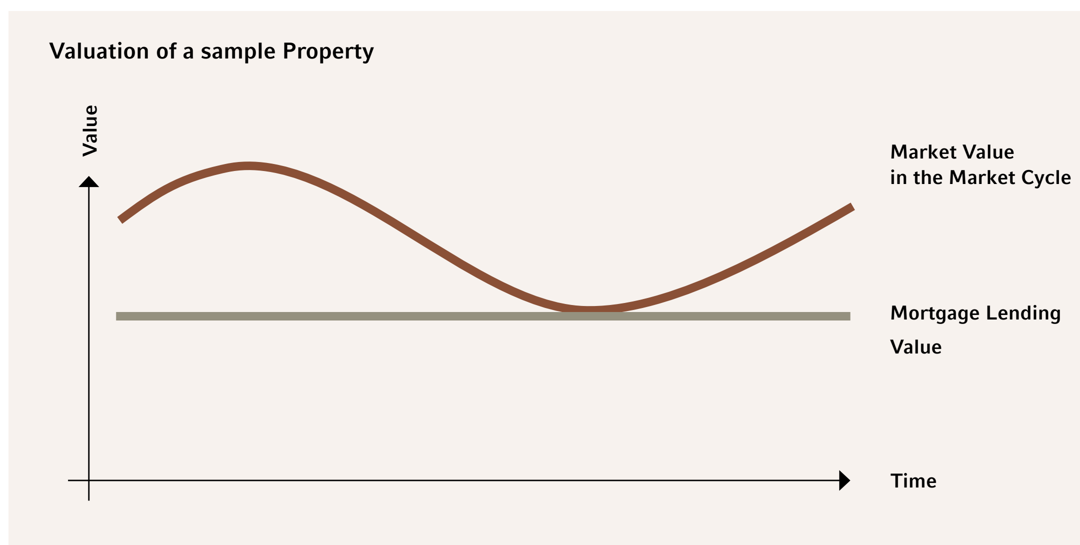
The Mortgage Lending Value is not an Artificial Value

Valuers have often criticised the Mortgage Lending Value in that it is seen as a synthetic and not a real value. This accusation can be countered by reference to the history of the property market and of the Mortgage Lending Value. In the 1990s the practice of making deductions from the Market Value became discredited. This method involved deducting of 15 % from all German Market Values (Verkehrswerte) with the result stated as the Mortgage Lending Value. Instead of this, an individual property-specific estimate as to the Mortgage Lending Value was prepared. The changeover to this more detailed method necessitated the introduction of a range of variables and lower limits (now laid down in the BelWertV), in order to ensure the continued sustainability of property values. The BelWertV shows that, depending on the position in the market cycle and the individual property, the extent of the correct differential

between the Market Value and the Mortgage Lending Value varies widely. Hence in a market in recession, as in the eastern part of Germany at the end of the 1990s, sometimes only very slight differences between the Market Value and the Mortgage Lending Value were recorded. On the other hand Mortgage Lending Values for example for residential complexes in the USA or retail warehouse parks in Britain were in part more than 40 % below the estimated Market Value in the boom period of 2004 to 2006.

This shows that in spite of the fact that definitions under the BelWertV, such as those for yields, operating costs or remaining economic life of the buildings are still not fully developed, the potential risk, if correctly applied, can be accurately factored in. The relationship between the Mortgage Lending Value and the respective Market Value can be shown in a simple schematic graph:

MORTGAGE LENDING VALUE AND MARKET VALUE COMPARED



This is however only achievable when the Mortgage Lending Value is not calculated mathematically as a function of the Market Value (effectively as its derivative). This would only once again lead to an artificial value, as with the process whereby a fixed percentage is deducted and where the peculiarities of the property itself are not sufficiently reflected. An independent estimate of the Mortgage Lending Value must therefore always be made.

The Mortgage Lending Value is not Related to the Loan Structure

Property is a long-lasting asset. The Mortgage Lending Value accounts for this in that it is built upon the secure, longer-term characteristics of the property, not on the funding ideas of the bank. There is no connection between the Mortgage Lending Value calculated by the valuer and the proposed loan amount or its structure. The term of the loan is also immaterial. The property alone determines the Mortgage Lending Value which is calculated using valid and recognised valuation techniques.

5 The Mortgage Lending Value International

On the international front, today's Association of German Pfandbrief Banks (formerly Association of German Mortgage Banks) adopted a definition of the Mortgage Lending Value in its valuation standards some years ago, these had already been published by TEGoVA (The European Group of Valuers' Association) in its so-called Blue Book in the year 2000. This definition appears again in the same form in the IVSC (International Valuation Standard Commission) directives. Last but not least and tantamount to a substantial accolade, it has been adopted in the Red Book, which sets down property valuation standards for RICS (Royal Institution of Chartered Surveyors) member valuers.

The incorporation of Mortgage Lending Values (MLV) in a national legal framework is, however, rare. Apart from in Germany, special legal standards for the valuation of real estate used as collateral for Covered Bonds are only in force in the Czech Republic, Poland and Spain and only Spain and the Czech Republic have their own regulations governing nation-specific Mortgage Lending Values. In several European countries, the MLV is nevertheless in evidence for financial purposes, this, however, mostly takes the form of a simple addition to the yields adopted for the Market Value and thus does not represent an independently assessed value. Additionally, these values offer no protection against the excesses of market volatility. In the Netherlands, the concept of forced-sale value is recognised among banks reflecting higher transaction costs and an extended marketing period by a deduction from the Market Value. It is worth mentioning, however, that an initial national model for the calculation of independent Mortgage Lending Values based upon Dutch valuation principles has been developed, and this is already being applied if required.

These cases and the examples of Vacant Possession Value cited above show that the need for such a valuation approach among professionals has existed for some time. It must be said, however, that many market operators have yet to discover what opportunities are on offer with the MLV. The current in the financial market crisis and above all its consequences for economies as a whole, which will concern us for a while yet, are causing a sea change towards a longer-term approach and hence automatically to a valuation which has relevance over such a timescale. Whether the German model is generally adopted or whether methods particular to individual countries will be developed is of secondary importance. Clients must above all be able to rely upon a valuation report containing a value which retains its validity over the longer term. This however must not be derived from the Market Value but must focus in the forefront on the sustainable features of the property.

6 Conclusion

In times where accountants are seeking sustainable values for their clients' property assets or in the context of a credit rating, where rating agencies are having to rethink their approach to structured finance products and not least where banks are reviewing long-term value sustainability in their property financing, the concept of sustainable value as against the volatile Market Value is once again to the fore. The Mortgage Lending Value, which in the past was treated as a specialist tool even by credit institutions, is revealing undiscovered potential in the present crisis in financial markets.

This concept of sustainable value excluding speculative elements is conducive to Pfandbrief Banks being able to refinance their property loans on attractive terms even in times of crisis through the issue of Pfandbriefe. Even if the strict definition of the German Mortgage Lending Value rules are still clearly not specific enough, and it would be desirable if methods dealing with the peculiarities of foreign valuation techniques had been agreed, the current security afforded by this approach is obviously very attractive in a crisis and is resulting in a competitive advantage not seen for months for the once so "boring" Pfandbrief Banks. When comparing Pfandbriefe internationally with Covered Bonds from England or Ireland, whose security is underpinned by the Market Value, for example, it is evident that the Pfandbrief has the advantage.

Securing the safety of the Mortgage Pfandbrief is the most essential role of the Mortgage Lending Value. Due to its longer-term approach, the Mortgage Lending Value concept could also contribute to a calming of very volatile property markets if it were applied more widely. Hence the continual updating of the Regulation on the Mortgage Lending Value (BelWertV), in preparation for a wider recognition, is an important focus in the work of the Association of German Pfandbrief Banks.