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Dutch Parliament permits automated valuation models in breach of European law … European Valuer reports

In last April's edition (No 3) of European Valuer, Pat Davitt, Institute of Professional Auctioneers and Valuers Chief Executive, summarised the findings of the Irish Parliamentary Committee of Inquiry's report on the banking crisis. Among its many findings, the Committee accused banks of over reliance on informal **"desktop"** and **"drive by" valuations** which did not involve any physical inspection of a property. Six months after the publication of the above report, it seems lessons have not been learnt, with the Dutch Parliament revising its law implementing the **Mortgage Credit Directive**, by allowing banks to grant mortgage loans on the basis of values estimated by automated valuation models (AVMs) without the input of a qualified valuer. Although the law does provide that if a property valuation is established on a model-based approach, the **loan-to-value ratio** may not exceed 90% – such law nevertheless runs counter to European law, as is made clear in a legal opinion commissioned jointly with TEGoVA Dutch members NVM, VBO Makelaar and VastgoedPRO.

An important aspect of The Mortgage Credit Directive (2014/17/EU) of 4th February 2014 concerns the fact that Member States must ensure that **reliable standards** apply for the valuation of residential immovable property for mortgage lending purposes.

During the plenary debate before the Dutch Parliament last March on the implementation of the Directive, a motion was filed in which it was stated that the Directive offered the possibility to value ... continued on page 2

All TEGoVA roads lead to Dublin for the autumn meeting

The Institute of Professional Auctioneers and Valuers (IPAV) looks forward to welcoming some **400 guests** to the 2016 TEGoVA Autumn General Assembly, to be held from **20th to 22nd October 2016** in the seaside town of **Malahide, Dublin, Ireland**.

In Ireland, IPAV has been to the forefront in adopting the highest European valuations standards, with 125 members now trained to REV standard and 250 as TRVs. The "Blue Book" EVS standard is recognised by the Irish Central Bank and the European Central Bank, for which it holds default status.

But of course we are just setting the groundwork in terms of building sustainability for the future. In Ireland we have gone from an oversupply of properties to now, eight years later, a very serious shortage, primarily in the main urban centres. Building came to a virtual standstill for most of those years and it means we now have huge unmet demand. Economic growth is also fuelling this demand, with the economy predicted to be by far the fastest-growing in Europe in 2016. The European Commission has recently predicted it will grow by 4.9% this year, with revised upward estimates for 2017 bringing it to 3.7%. This contrasts with the Eurozone average of 1.6% growth expected this year.

Property prices decreased by an average of 60% from 2007 to 2013, but so strong was the initial growth spurt during 2014 that it prompted the **Central Bank of Ireland**, concerned about the potential for another property bubble to emerge, to introduce strict new mortgage lending rules which are amongst the most onerous in Europe. These are the subject of intense public and political debate, with it taking, on average, six years and six months to save for the deposit needed to buy a home.

IPAV President, **Alan Redmond**, will welcome our popular TEGoVA colleague **Luke Brucato** as conference moderator, and along with the expertise of familiar colleagues **Krzysztof Grzesik**, Chairman of TEGoVA and **Roger Messenger**, Chairman of the European Valuation Qualifications Board, we will have a range of diverse inputs from the UK, as Brexit and its potential implications for the European Union reverberate around the continent.

We will be honoured to have present our Minister for Housing, Planning, Community and Local Government, Simon Coveney. Since his appointment to the portfolio just over four months ago, his commitment to solving the dogged impediments to what could be considered a normal housing market has been hugely energetic and serious.

The diverse programme will not only include presentations from key UK professionals, but contributions from the USA and Canada too. More information on the conference programme and other events can be found on the TEGoVA website at **tegova.org**

We look forward to extending a very warm Irish welcome to all our guests and to a very lively discussion too. We also hope that the event will lead to new insights and a better informed debate about property valuation in Ireland and across Europe long after the conference is over. ●

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The TEGoVA Netherlands team show their strength at the 2016 PROVADA event

the property *"by other means than an expensive valuation report"*. The motion requested the government to adopt a decree to allow **model-based valuations** of residential property or the use of the purchase price in case of less risky mortgages. Accordingly, a draft decree was prepared by the Cabinet to allow valuations using the model-based method and despite the protests of TEGoVA Netherlands, the decree was signed by the King and published on the 13th July 2016.

The legal opinion received by TEGoVA analyses in detail the extent to which a **"pure"** model-based valuation complies with the European legal framework, including an analysis of the Mortgage Credit Directive, the **Capital Requirements Regulation (EU) No 575/2013** of 26th June 2013 and the internationally recognised valuation standards, including **European Valuation Standards**.

The legal opinion makes reference to the report of the Parliamentary Committee of Inquiry of 27th January 2016 into the Irish banking crisis. Among its many findings, the report stresses that the use of "pure" AVMs was one of the reasons for this crisis:

"Accordingly, a draft decree was prepared by the Cabinet to allow valuations using the model-based method and despite the protests of TEGoVA Netherlands, the decree was signed by the King and published on the 13th July 2016."

"More widely, however, the demand for asset valuations increased significantly as the property boom took hold and reliance on informal valuation standards, such as 'desktop' and 'drive-by' valuations, became more prevalent. These did not involve any physical inspection of the property, but were a limited (and sometimes fully automated or computer generated) process of estimating value. A Central Bank review of financial institutions found that many used these informal valuations as if they were formal valuations."

The Mortgage Credit Directive lays down the requirement for all valuations to be carried out by a qualified and independent valuer on the basis of reliable standards and they are to be documented in substantiated valuation reports prepared with appropriate professional skill and diligence. The use of AVMs without review by a qualified valuer does not meet the requirements of the Mortgage Credit Directive. This view is also **supported** by the express reference in recital 26 of the Mortgage Credit Directive to the internationally recognised valuation standards developed by **IVSC**, **TEGoVA** and **RICS**. These standard setters have issued guidelines which exclude the use of AVMs without control mechanisms by a qualified valuer or physical inspection of the property. In particular, European Valuation Standards 2016 provide that **"pure"** AVMs do not guarantee a reliable valuation.

The need for a valuation to be carried out by a **qualified valuer** is made even clearer in the **Capital Requirements Regulation** (CRR). Thus, in CRR article 229, it is explicitly and unambiguously stated that the intervention of an independent valuer is required for the valuation of immovable property collateral in the context of the internal ratings based or IRB-approach:

"For immovable property collateral, the collateral shall be valued by an independent valuer at or at less than the market value. An institution shall require the independent valuer to document the market value in a transparent and clear manner.

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 at less than the mortgage lending value. Institutions shall require the independent valuer not to take into account speculative elements in the assessment of the mortgage lending value and to document that value in a transparent and clear manner.

The value of the collateral shall be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under Article 208(3) and to take account of any prior claims on the property."

CRR Article 208 (3) further provides the following requirements on *"monitoring of property values"* and on *"property valuation"*:

"*(a) institutions monitor the value of the property on a frequent basis and at a minimum once every year for commercial immovable property and once every three years for residential real estate. Institutions carry out more frequent monitoring where the market is subject to significant changes in conditions;*

(b) the property valuation is reviewed when information available to institutions indicates that the value of the property may have declined materially relative to general market prices and that review is carried out by a valuer who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process. For loans exceeding EUR 3 million or 5% of the own funds of an institution, the property valuation shall be reviewed by such valuer at least every three years.

Institutions may use statistical methods to monitor the value of the property and to identify property that needs revaluation."

According to the above provision, statistical methods (including AVMs) can only be applied to **monitor** the value of the property and to **identify** property that needs revaluation. The use of such methods, however, is not allowed for the actual valuation of the immovable property. This obviously applies to the original or first-time valuations where no value has yet been established and can be monitored.

"According to the above provision, statistical methods (including AVMs) can only be applied to monitor the value of the property and to identify property that needs revaluation."

Conclusion

The legal opinion concludes that whilst AVMs are not prohibited, **"pure"** AVMs with no intervention or supervision of a qualified valuer do not meet the strict requirements of the Mortgage Credit Directive and the Capital Requirements Regulation.

Furthermore, such conclusion is supported by the **internationally recognised valuation standards** and guidelines issued by other institutions. It follows that the use of AVMs without human verification or without physical inspection of the property cannot be allowed.

In the light of the foregoing, TEGoVA on 29th September filed a formal complaint with the European Commission with a view to overturning this **questionable** piece of legislation. Failure to do so may have a knock-on effect in other EU member states. Watch this space! ●

We are in an uncertain world, concludes David Magor, as he examines the first effects of the UK's EU referendum vote

As we all know, the United Kingdom (UK) has elected to leave the European Union (EU). This is an historic decision for the UK and Europe. After 43 years of membership, the British public has decided to sever ties. Whichever way you look at it, it's a **shock outcome** that will profoundly alter the political, economic, and financial landscape for the UK and the EU. This move will undoubtedly have profound consequences for the valuation profession, both in the short term and the long term. We are now in the aftermath of the vote and we are seeing unpredictable shifts in the economy, which will impact on the valuation process. Although these initial shockwaves are limited, **the long term outlook remains uncertain**. Even though we are in an unprecedented situation, provisions do exist in treaties to allow for a stable transition on exit. Of course, it is also important to recognise the special situations that prevail in Scotland and Northern Ireland and the frustration that is being experienced in these devolved administrations, particularly because they voted to remain.

There are many issues in the exit process that will affect the day-to-day work of the valuer in both the public and private sectors. There are, for example, 80,000 pages of EU law. Whilst the EU Directives would no longer be binding, we will have implemented them in UK laws. Much of the statute and regulation currently applicable in the UK derives from EU legislation. These statutes and regulations will remain applicable until any changes are made, which will be a matter for Parliament. Valuers must continue to abide by their obligations under UK law, including those derived from EU law.

Consumers' rights and protections, including any derived from EU legislation, are unaffected by the result of the referendum and will remain unchanged, unless and until the government changes the applicable UK government legislation.

Now we must start to look to the future and the process of withdrawing from the EU. As I am sure you are all aware, the EU referendum result is **not legally binding**, so in theory Parliament could ignore the will of the people by deciding to stay in the EU. This is because Parliament is sovereign and the EU vote was an "**advisory referendum**", as opposed to a "**binary**" referendum, which has a fixed outcome. In contrast, the legislation for the UK's last referendum in 2011 would have forced the government to change the law if the public had voted for a new voting system, whereas the EU referendum legislation does not force the government to automatically take Britain out of the EU. However, the political reality is that the government has no choice but to follow through on the electorate's wishes, irrespective of the need to gain a positive Parliamentary vote to activate Article 50. There is **no timescale** for how soon after a referendum Article 50 must be invoked. However, the government is under pressure to start the process as soon as possible, in order to put an end to the uncertainty that has engulfed Europe. The Article itself is set out in the **Lisbon Treaty**. It is the legal mechanism for the withdrawal of a Member State from the EU. The use of Article 50 will start the timer on a two-year process of exit talks over Britain's political divorce from the 28-member bloc. At the end of the two-year period, Britain could be expelled from the EU, unless Member States unanimously decide to extend the deadline.

Since the result of the referendum was announced, it has been possible to begin to gauge the long term effect of this decision on the valuation of land and buildings by reference to transactions in the market place. Usefully, TEGoVA's latest **European Valuation Standards (EVS 2016)** deal with uncertain markets, acknowledging that, where there is market volatility, a reduced level of certainty may be a factor in the valuation. This recognises that it is difficult to make a firm judgement when the reaction or future movement of the market is unknown. Notwithstanding these challenges, the valuer is still required to make that judgement. Guidance confirms that, when reporting, practitioners must comment on any issues that are affecting the certainty of the valuation. The valuer must ensure that the context of his or her conclusions are clearly thought through, and then fully and clearly expressed and documented in any report.

> ***"Much of the statute and regulation currently applicable in the UK derives from EU legislation. These statutes and regulations will remain applicable until any changes are made, which will be a matter for Parliament."***

The timeline for exiting the EU could be at least five years and the markets will remain uncertain throughout that period. The valuer must therefore continue to be cautious about the potential for longer term outcome volatility.

Needless to say, these few paragraphs have only scratched the surface of the numerous issues that will crop up over the next five years. Forthcoming issues of this journal will no doubt endeavour to explore the wider issues and challenges that will face the profession. In particular, they will include a **detailed analysis** of the impact of "**Brexit**" on valuation for property tax and the potential areas for challenge.

There will also be comment on specific matters such as state aid, regeneration, public procurement, data protection, data sharing and employee rights, to name but a few! ●

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Warsaw case study issues a warning about the futility of forecasting rental growth

Rents for office space in Warsaw have been constantly falling. In 1995 prime office buildings in Warsaw were leased at €48/m2 per month. Today rents stand at about half that figure. The most spectacular falls were observed in the first 11 years of the fledgling market as a result of both the growing supply and a maturing market. Rental increases were observed only during 2006 – 2008 and 2011 – 2013. Currently, given a large oversupply, the **trend is again downwards**. Thus, in the last 21 years we have witnessed 15 years of falling rents and only six years of rising rents.

Meanwhile, the market practice amongst valuers in Poland has been to forecast cash flows assuming rental indexation typically at around **2% annually**. But has this been defensible?

If a 2% annual rental increase had been assumed in 1996, today the rental level would be €67 per m² per month. The same assumption made in 2000 would lead us to €41 per m² per month today. Short-term forecasts are closer to the mark. Thus assuming a 2% annual growth rate in 2010 would give us a rent today of €28 per m² per month compared to the **actual market level** of €23.5 per m² per month.

However, the declines in rental rates do not rule out the profitability of office investments, because at the same time yields have fallen and the value of buildings per m² has increased.

The return on an office investment is also affected by factors such as costs and availability of financing and the effects of leverage, which in recent years worked in favour of investors.

The cost of financing has fallen significantly since the 1990s, leading to the **growth of returns** on real estate investments. In February 1998 the bank reference rate, as determined by the **National Bank of Poland,** for the first time stood at 24%. Today it is down to 1.5%.

Prime office yields are also falling. The first transaction in Poland, in respect of a commercial building in 1997, was agreed at a yield of 13.25%. This was the sale of the Wiśniowy Business Park A office building for €13.5 million. Today prime yields in Warsaw are at the **historically low level** of 5.5%, much higher than the rate on ten-year government bonds, which currently stands at 2.5%.

Thus, the value per m² of prime office buildings has been rising. In the mid-1990s, the best office buildings were valued at approx. €3,900 per m². Today the corresponding value is up to between €4,500 and €5,000 per m². As a result, even with falling rents, commercial real estate still ensures good capital returns. ●

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