The Central Bank of Ireland
Valuation Processes in the Banking Crisis – Lessons Learned – Guiding the Future
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Aide Memoire / Checklist

Capital Requirements Directive
1. Valuation Processes - Guidance and Recommended Practice

1.1 Introduction

This paper addresses a commitment made by the Central Bank of Ireland (“the Central Bank”) to provide credit institutions with details of lessons learned from the banking crisis, and to provide guidance on recommended practice, as a means of ensuring credit risk management standards are appropriate for future demands.

In this paper, we:

- Provide Guidance on the valuation standards recommended for use by credit institutions for valuing property assets which are held as part of security package and the attendant implications for impairment provisioning purposes.
- Outline the primary weaknesses in Credit Institution valuation processes that arose during the boom in property market lending and provide Recommended Practice.

This guidance material complements our paper ‘Impairment Provisioning and Disclosures Guidelines – December 2011’ as the valuation of collateral is a key consideration in determining impairment provisions.

1.2 Application

This paper applies to all Credit Institutions. While this paper has the status of guidance, the Central Bank considers that the guidelines and recommendations contained herein represent appropriate process and procedures for credit institutions in considering property security valuation. As such, the Central Bank would consider material deviations from this guidance as contrary to good practice. The Central Bank will, as a matter of course, scrutinise the application of these guidelines as part of its on-going supervision.

1.3 Valuation Standards

The Central Bank is not seeking to review or challenge valuation methodologies. From the perspective of the Central Bank, The Royal Institution of Chartered Surveyors ‘Red Book’ of valuation standards is consistent with the principle rules of international Valuation Standards and is considered to be appropriate practice and compliant with the Capital Requirements Directive (CRD).

The ‘Red Book’, details the areas, as a minimum, to be covered in the confirmation of the terms of engagement with a Valuer. The Central bank observed that many had been overlooked, omitted and in some cases totally disregarded during the property market boom. These are in place for the protection of the Credit Institution, the borrower and the valuer.

Section 2 of this paper highlights the main valuation principles and their applicability in a market that is subject to falling prices and limited demand. In particular section 2, consistent with the paper, ‘Impairment Provisioning and Disclosures Guidelines – December 2011’ emphasises the conservative approach required for valuations. In commenting on the valuation standards and their applicability in the current market, the Central Bank has considered valuations under headings as follows:
1. Valuation Processes - Guidance and Recommended Practice (continued)

1. The Basis of valuation
2. Valuation methodology and provisioning
3. Frequency of valuation
4. Responsibilities for valuation

1.4 Primary Weaknesses in Valuation Processes

In section 3 of this paper the Central Bank provides an overview of the primary weaknesses in commercial and residential property security valuation process that arose during the boom lending years. The purpose is to provide a valuable summary of the Lessons Learned and recommendations regarding good practice going forward. The Recommendations are to be read in conjunction with the general principles outlined in section 2 of this paper.

The Central Bank has identified three over-riding areas of weaknesses:

1. Inaccurate or inappropriate definition of valuation requirements by Credit Institutions and subsequent inadequate assessment and understanding of valuations received.

2. Inadequate valuation processes and standards or a disregard for adherence to such processes.

3. Lack of appreciation of the significance of the valuation document as independent evidence of risk mitigation effectiveness. Many bankers did not fully regard the valuation report as a key document underpinning the basis on which they were acquiring the risk.

Following release of this paper Credit Institutions are required to review their valuation processes and ensure that they are appropriately documented and implemented, paying particular attention to the matters raised in section 3 of this paper.
2. GUIDANCE ON VALUATIONS

2.1 The Basis of Valuation

The Royal Institution of Chartered Surveyors ‘Red Book’ of valuation standards is consistent with the principle rules of international Valuation Standards and is considered to be appropriate practice and compliant with the Capital Requirements Directive (CRD).

The basis of Market Value is an internationally recognised definition. It is defined as “the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after property marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”

Market value is an appropriate basis of value that can be used in all valuations or appraisals undertaken for secured lending. Any special assumptions made in arriving at the Market Value should be agreed between the lender and valuer prior to the valuation report being prepared. If a valuer is aware of any other circumstances, which could affect the price, these must also be drawn to the attention of the lender, and an indication of their effect provided. Credit institutions must ensure in their instructions to valuers that such circumstances are included in the valuers report to the institution. All valuations are subject to assumptions and there is no such thing as a standard assumption which can be implied without being stated. There are also special assumptions which arise where it is necessary to assume something that is different from the status quo or where an assumption made in the valuation would not normally be made by the market. Such assumptions or considerations should be supplied with the valuation figure in order to act as a guide as to the factors which have been considered in the valuation.

2.2 Valuation Methodology and Provisioning

There has been much discussion concerning the basis of valuation in a market with little or no demand. The view of the Central Bank is that a revised Red Book valuation is the most appropriate way to update the value of the security held by the Credit Institutions. In a falling property market, Credit Institutions should incorporate further downside movements in the valuation to inform the extent to which the actual value could fall. This is important information for loss forecasting and provisioning decisions.

In our paper ‘Impairment Provisioning and Disclosures Guidelines – December 2011’ we have outlined the basis on which loan provisions should consider property valuations where the bank has a security charge on that property.
2. GUIDANCE ON VALUATIONS (continued)

The ‘Impairment Provisioning and Disclosures Guidelines – December 2011’ state:

When conducting a specific assessment for impairment, the Central Bank expects a more conservative approach to the estimation of both the future cash flows and the collateral valuations. The estimates and assumptions should reflect the current economic challenges and a current view of the expected economic outlook. When determining the collateral valuations in the cash flow calculation, a more conservative approach should be applied to both the expected timing and the amount of the proceeds.

In relation to CRE exposures, by extending forbearance measures to borrowers, Institutions provide additional time to borrowers to adjust their Balance Sheets without immediately crystallising losses. The Central Bank believes that the tight credit markets could impact future refinancing risk. Accordingly, when undertaking a CRE impairment assessment, the impact of future higher re-financing risk should be particularly considered. This is to reflect the fact that if an exposure cannot be repaid at the contractual date, the refinancing of the exposure may not be achievable and this may have a corresponding impact on the recoverability of the exposure.

There is specific reference in International Accounting Standard (IAS) 39 to foreclosure;

“The estimation of the recoverable amount of a collateralised exposure reflects the cash flows that may result from foreclosure where foreclosure is considered the likely course of action”.

With regard to foreclosure the ‘Impairment Provisioning and Disclosures Guidelines – December 2011’ state:

Where foreclosure proceedings have been initiated and the expected time to security realisation is prolonged and or delayed, the Central Bank expects that valuation of the underlying security should be reviewed on a regular basis.

2.3 Frequency of Valuation

Credit Institutions should implement the Property Valuation rules as per the Capital Requirements Directive (CRD), see Appendix 2. Previously we noted that some developers and credit institutions postponed formal revaluations for as long as possible. Borrowers frequently took the maximum period allowed under their Credit Institution covenants before seeking formal revaluations and Credit Institutions did not pursue them for earlier updates. Credit Institutions applied their own informal haircuts to security values which did not fully reflect the erosion of value in the property held. This practice is not acceptable under the new guidelines for Impairment Provisioning (December 2011). Valuations are required to be completed on a more regular basis, particularly as noted in the CRD where the market is subject to significant change. A more conservative approach should be applied to both the expected timing and the amount of the proceeds included in the provision assessment.

2.4 Responsibilities for Valuations

Valuations methodologies are about assumptions and judgements. These have to be decided by Senior Management under usual governance requirements and the Central Bank has no role in recommending or setting specific assumptions or inputs for valuation methodologies. There are clearly defined industry rules for Valuers, which we support, and accounting rules as to how these are used in determining appropriate loan loss provisions.
3. Primary weaknesses in Valuation processes

Lessons Learned – Key Findings

The primary weaknesses in valuation processes identified by the Central bank are summarised below.

3.1 Weaknesses in instructions given to valuers: Poor valuation instructions were a contributing factor to the level of property losses incurred by Lenders. Valuations based on vague instructions provided inaccurate values and therefore inaccurate assessments of risk at the time of underwriting.

3.2 Conflicts of interest are unacceptable: During the volume led transaction phase of the boom in property development, certain valuation practices were accepted by credit institutions that involved significant conflict of interest.

3.3 Valuer panel management: There were weaknesses in the appointment, utilisation and performance review of valuer panels by credit institutions. This included the utilisation of valuers without appropriate experience, qualifications and professional indemnity insurance for the particular assignment.

3.4 Frequency of valuation review / underassessment of provisions: Credit institutions often failed to conduct regular valuations, thereby avoiding the issue of recognising value diminution resulting in under-assessment of impairment provisions.

3.5 Inappropriate use of informal valuations: During the property lending boom, there was increased reliance on informal valuations by credit institutions. These were utilised as if they were full valuations. To properly assess risk during lending reviews, full valuations are required.

3.6 Valuation inputs in credit decisions and risk management: Credit institutions did not sufficiently consider sensitivity analysis in the assessment of property values and credit risk.

3.7 Training was inadequate: There was inadequate training regarding collateral valuation methodologies, interaction with professional valuers, the interpretation of valuation reports and the importance of valuations in credit risk assessment.

These weaknesses are described in more detail in this section and are accompanied by Recommended Practice guidance.
3. Primary weaknesses in Valuation Processes

3.1 Weakness in instructions given to valuers

OBSERVATION

Poor valuation instructions were a contributing factor to the level of property losses incurred by Lenders.

Credit institutions were often negligent and imprudent in the manner in which they requested property valuations. There was often a lack of specificity attaching to requests for valuations or inadequate or inappropriate assumptions provided. There was also a general lack of knowledge of some lenders of the appropriate valuation requirements and assumptions and the manner in which the valuations were to be interpreted.

In many cases, clear written instructions were not provided by credit institutions to valuers and often valuation requests were by means of telephone rather than written process. Valuations based on vague instructions have provided inaccurate values and therefore inaccurate assessments of risk at the time of underwriting.

In some instances the lending staff of the Credit Institution may have been motivated to obtain a valuation that supported the price paid and the funding requirement rather than to support a proper risk assessment of the loan.

In some development loan valuation reports, the valuations reflected the projected value at a future completion milestone. Some lenders interpreted this future value as the current actual value of the project thereby assuming that zoning and planning were granted, construction completed according to budget and sales would be ultimately achieved in full.
RECOMMENDED PRACTICE

1) Credit Institutions should standardise all valuation processes. This allows for consistency and accurate analysis of a project and consistency across the credit institutions loan portfolio.

2) Letters of instruction should be incorporated into the valuation report to ensure that the basis and assumptions are as required. They should include at a minimum:
   1. The purpose and subject of the valuation
   2. The interest to be valued
   3. The basis of the valuation
   4. Assumptions or concerns that the credit institution may wish to be considered.
   5. Other information of which the valuer is aware that may be of importance to the credit institution

3) Other matters, which the credit institution should consider including in the report:
   - Potential and demand for alternative uses, or any foreseeable changes in the current use.
   - Contamination or environmental hazards.
   - Past, current and future trends in the property market in the locality and/or demand for the category of property.
   - Current marketability of the interest and whether this is likely to be sustainable over the life of the loan.
   - Viability of development schemes and implications on value of cost overruns and contract delays.
   - For development loans, lenders need to take a prudent approach to the valuation of work in progress and provide clear instructions to valuers.
3. ISSUES AND RECOMMENDATIONS

3.2 Conflicts of interest

OBSERVATION

During the volume led transaction phase of the property development boom, certain valuation practices were accepted by credit institutions that involved significant conflict of interest.

Where a conflict of interest exists the valuation is not independent and accordingly it is much more likely that the valuation provided is neither robust nor reliable. All valuations include judgements but, where a conflict of interest exists, it is more likely that such judgements are biased and not in favour of the lender.

In many instances lenders accepted existing valuations that had been prepared by valuers on behalf of the borrower. In other instances, valuation instructions were issued by a developer to the valuer and the reports, based on these instructions, were accepted by the banks. In addition, the credit institutions did not sufficiently prescribe or determine the source of valuation reports from within property firms and often accepted valuations prepared by the sales division rather than independent and expert valuations prepared by the Valuations division within these firms.

RECOMMENDED PRACTICE

1. The Valuers duty of care is to the Credit Institution – Credit institutions should emphasise this in their written instructions to valuers.

2. Credit institutions should require valuers to disclose any material involvement in a property, or a statement that there has not been any previous material involvement’ in the property.

3. Credit institutions should not use valuers in the following circumstances: a) where the valuer has acquired the property on behalf of the borrower, b) where the valuer is involved in the sales or letting of a property against which the institution has lent either to developer or is considering lending to a potential purchaser.

4. Where, in exceptional circumstances, valuers have a relationship with the Credit Institutions customer and the Credit Institution wishes to use the valuer – a clear separation of responsibilities within the valuation firm needs to be declared in writing and also an outline of how independence is maintained.

5. Instructions to Valuers for Property Valuations as collateral security should come from the Credit Institution. Fees should only be discharged by the credit institution; fees should not be paid by any other party to avoid conflict of interest issues arising.

6. Valuation reports should be addressed to the specific credit institution that is advancing the loan funds
3. ISSUES AND RECOMMENDATIONS

3.3 Management of Valuer Panels

OBSERVATION

There were weaknesses in the appointment, utilisation and performance review of valuer panels by credit institutions.

Banks failed to properly document and manage the process and procedures governing the appointment of valuers to panels and to define the activities for which each panel member was qualified or experienced. Very often panel members were locally appointed by regional bank managers and the credit institution did not maintain a unified panel with standardised appointment and engagement processes.

As a result there were instances in which valuation appointments were not assigned to valuers with the requisite experience and inappropriate valuations were utilised by the credit institution.

There was little or infrequent review of performance or capability of valuers included on valuation panels. Such a review process is a control mechanism to ensure that valuations are properly performed and utilised by the banks. The absence of such reviews resulted in the continuation of poor practices and continuing use of valuers in inappropriate circumstances.

Some of the weaknesses identified by the Central Bank include;

- Appointment without sufficient qualifications
- Appointment without evidence of sufficient professional indemnity insurance
- Appointed of valuer on basis they are a customer of the bank
- Utilisation of valuers without the appropriate experience for the particular assignment
- Inadequate or no review of panel members performance
RECOMMENDED PRACTICE

1. Credit Institutions should have a properly approved panel of valuers using appropriate selection criteria consistent with the loan portfolio risk. An institution should have on-going assessment of performance to enable a valuer remain on the panel. This assessment should include a review of a Valuers performance and professional indemnity insurance.

2. A panel of valuers should contain expertise in various areas of the property sector appropriate to the lending business of the institution and the location of lending. This may, for example, include expertise in development sites, commercial investments, hotels, public houses, golf courses and agricultural land and farms.

3. The experience of the valuer should be commensurate with value of the loan and risk to the credit institution.

4. Where the value of the loan to be advanced is in excess of €25m, the Credit Institution should seek a full ‘Red Book’ Valuation from more than one Valuer.

5. Credit Institutions should ensure that no one firm of Valuers has the bulk of their valuations. Consideration should be given to having no one valuer doing more than, say, 33% of all valuations.

6. Credit institutions should report any concerns in relation to non-ethical behaviour, including instances of unrealistic valuations, to the RICS. In such circumstances, CBI recommends that credit institutions remove such valuers from the panel which effectively bans them from working with the credit institution.

7. Where a credit institution is concerned about negligence or non-ethical behaviour by a valuer, it should:
   (a) Report them to RICS
   (b) Consider legal action to recover losses
3. ISSUES AND RECOMMENDATIONS

3.4 Frequency of valuation review / underassessment of provisions

**OBSERVATION**

Credit institutions often failed to conduct regular valuations, thereby avoiding the issue of recognising value diminution resulting in under-assessment of impairment provisions.

Subsequent to the on-set of the financial crisis, credit institutions were very slow to recognise the impact of falling property prices on collateral values and therefore on the recoverability of their loans. In some cases the Central Bank noted it was 3 years since a full independent valuation had been performed. In other instances there was a lack of evidence that an independent assessment had occurred on loans that were obviously impaired or restructured.

A key challenge noted by credit institutions was obtaining valuations in an illiquid and falling property market. However, as noted in section 2 of this paper Credit Institutions should incorporate further downside movements in the valuation to inform the extent to which the actual value could fall. This is important information for loss forecasting and provisioning decisions.

In particular several key weaknesses were noted:

1. Instances where either
   (a) No collateral valuation policies existed or
   (b) Policy inadequately addressed the valuation requirements and valuation frequency.
2. In the case of Commercial Real Estate portfolios, evidence of an independent professional assessment of collateral value for impaired or restructured exposures was often absent.
3. In cases where it was a number of years since a valuation was completed, sometimes the only file update was a valuation estimate by a relationship manager based on an outdated valuation with a haircut applied. While this leads to a write down in the collateral value, it carries no real independent basis and almost consistently has been overly optimistic.

In addition to the Recommended Practice in this section credit institutions must have regard to the Guidance on Valuations in section 2.
RECOMMENDED PRACTICE

1. Credit Institutions must follow the Property Valuation rules as per the Capital Requirements Directive. See Appendix 2.

2. Credit Institutions should have clear policy and guidelines governing valuation frequency. The Policies should be reviewed with other policies at least annually. The policies should reflect the external environment. This valuation frequency should also reflect the size of the risk and the complexity of the asset. The frequency policy should set a fair but challenging minimum standard.

3. Where there has been a material change (positive or negative) to the property by way of zoning, planning permission, densities, compulsory purchase order, transport links, completions etc. a revised valuation of the property should be sought.

4. CBI would not expect to see a full professional revaluation of a property every 6 months where no assumptions have changed except perhaps for market conditions. Valuation frequency for larger transactions should be assessed on a case by case basis.

5. For volume valuations like House Mortgages, an Index is an appropriate method for review provided the Index itself is assessed regularly. If a significant house mortgage is in difficulty then a specific valuation should be obtained.
3. ISSUES AND RECOMMENDATIONS

3.5 Inappropriate use of informal valuations

OBSERVATION

During the property lending boom, there was increased reliance on informal valuations by credit institutions. These were utilised as if they were full valuations. To properly assess risk during lending reviews, full valuations are required.

A valuation report is a core document in the risk decision and risk review process and should therefore be processed, reviewed and approved in a similar manner to other security and loan documentation. However, many valuations utilised by credit institutions were informal; either recorded conversations with the valuer, short notes from drive-by assessments or desktop research.

Such reviews may be useful to provide a tactical view of a loan. However, it must be clearly documented that these reviews are only tactical and not to be relied upon for proper risk assessment purposes. In reviews we noted situations where such valuations were effectively the only valuation available.

RECOMMENDED PRACTICE

1. Credit Institutions should have appropriate processes to flag outdated valuations and trigger full valuation updates. This can be in line with appropriate review dates for the Loan itself.

2. Processes should ensure an appropriate audit trail and clear description of the valuation on file.

3. Standardised templates for desk-top or drive-by valuations should be utilised to ensure clear identification of the type of valuation and to ensure consistency of identification across all files. Such valuations should have a clear warning that they have limited value.

4. Loan templates should provide a summary of the last two valuations and specifically when the last full independent valuation was done with less prominence to “quick values”
3. ISSUES AND RECOMMENDATIONS

3.6 Valuation inputs in Credit decisions and Risk Management

OBSERVATION

Credit institutions did not sufficiently consider sensitivity analysis in the assessment of property values and credit risk

Property valuations are a component of the risk assessment toolkit and should be used as such rather than in isolation and without examination of downside risk sensitivities. Professional valuers make judgements based on their knowledge and the assumptions provided to them. It is therefore incumbent on credit institutions to consider various parameters and to test the sensitivity of the valuations to different inputs e.g. level of planning density, supply and demand, potential yield shifts, impact of reduction in target house prices, uplift in building costs, etc.

The credit institutions failed to conduct reasonable stress testing during the property boom. Simple sensitivity analysis would have revealed significant risks and dependency on upward only projections. Scenario analysis stress testing involving downside macro-economic scenarios would have further revealed dependencies in the loan books.

RECOMMENDED PRACTICE (This list is not exhaustive)

1. There should be a greater use of sensitivity analysis in the valuation process, particularly with regard to costs, yields, end values, finance, rental income and the length of the construction period.

2. Feasibility studies and business plans should be prepared for larger schemes, especially for mixed schemes. Every assumption on feasibility needs to be examined and the impact of a change to each should be analysed.

3. In addition to sensitivity analysis, credit institutions should consider the impact of property values in their scenario stress testing. Greater consideration needs to be given to all inputs in a valuation, including location (long and short term prospects), infrastructure, (long and short term), services, planning (long and short term), zoning, supply (micro and macro) demand (micro and macro), rental levels, covenant strength, vacancy (long and short term) cost of funds, contamination, ecological issues, size and configurations, building costs, scale and phasing of the any development and the overall timing of the development.
3. ISSUES AND RECOMMENDATIONS

3.7 Inadequate Training

**OBSERVATION**

There was inadequate training regarding collateral valuation methodologies, interaction with professional valuers, the interpretation of valuation reports and the importance of valuations in credit risk assessment.

There was lack of understanding regarding the importance of clearly-defined independent valuations in the credit risk assessment process. There was also poor understanding regarding appropriate valuation instructions and interpretation of valuation reports received from professional valuers.

In addition, lending volume targets inappropriately drove lending behaviours and the importance of independent collateral valuations in credit risk assessment was often over-looked. The lack of training on interpretation of valuations and valuation methodologies exacerbated such behaviour.

**RECOMMENDED PRACTICE**

1. When policy and process are upgraded it’s crucial that the knowledge gaps on Valuations are improved through training.

2. It is recommended that the Relationship Managers and Credit staff are specifically trained in property valuation methods and processes.

3. Credit institutions should consider the establishment of in-house expertise in property valuation methodologies. Such expertise may be used to inform in-house training requirements and standards.
Any eligible real estate collateral must comply with specific conditions in terms of legal certainty, monitoring of property values, documentation and insurance in order to be recognised. In terms of the requirement to monitor property values, the provisions note that "the value of the property must 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 (see definition below) 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 own funds of the Credit Institution, the property valuation must be reviewed by an independent valuer at least every three years." An 'independent valuer' is defined in Annex VIII, Part 2, Point 8 as "a person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process".

APPENDIX 1: VALUATION MANAGEMENT AIDE MEMOIRE

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<th>VALUATION PROCESS</th>
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