Mortgage Lending and Other Bank Lending Valuations. A Quality Valuation?

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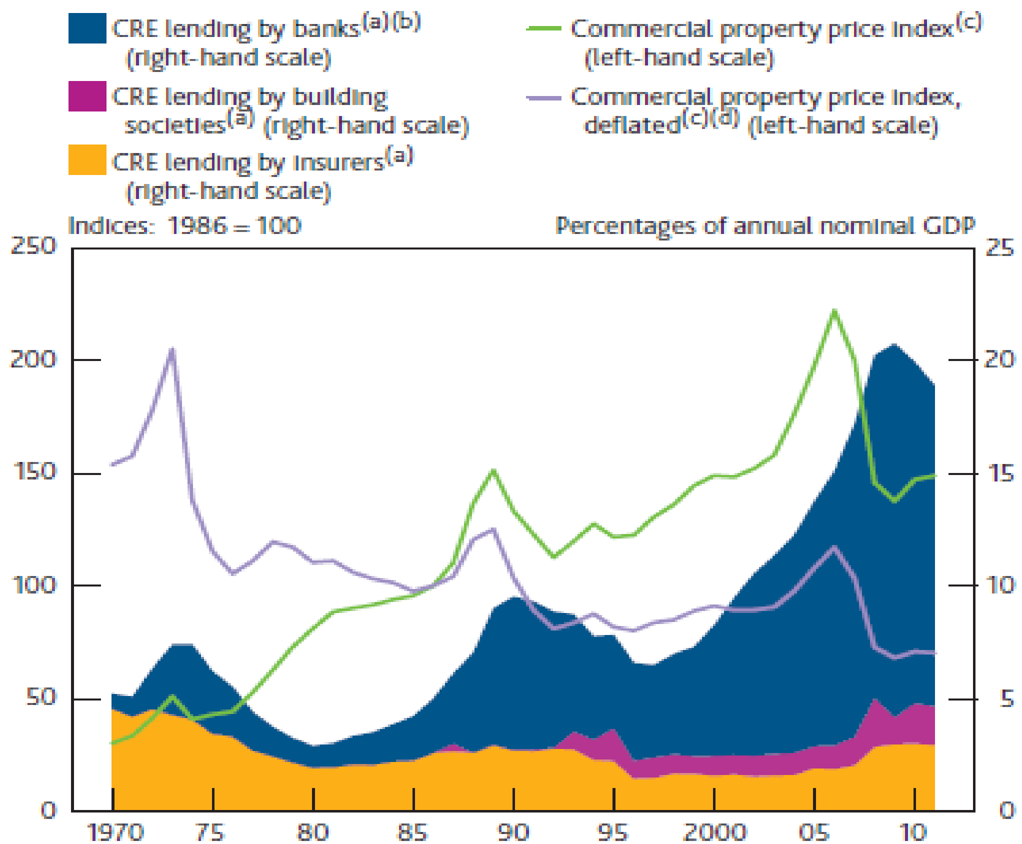
What is the problem?

- Link between property market booms and bust and bank lending? (BOE, Quarterly Bulletin, Q1 2013)
- Pro-cyclical nature of bank lending valuations?
- Do we need a “better” valuation basis?

Chart 1 UK commercial property debt and valuations



Sources: Association of British Insurers, Bank of England, Building Societies Association, Investment Property Databank, ONS and Bank calculations.

(a) End-year stock of outstanding lending.
(b) In 2010 and 2011 this includes an adjustment to include CRE loans transferred to the Irish National Asset Management Agency.
(c) Based on end-year data.
(d) Deflated using GDP deflator.

What is the problem?

- In addition to the potential link between property market booms and bust and bank lending.
  - Link between property lending and property valuation.
- Property at the heart of the financial crisis.

> *"The shock from the fall in property **prices**, even from their inflated levels of a few years ago, should not have caused havoc on anything like the scale experienced. Rather than suffering a 'perfect storm', we had severe weather that exposed a damagingly rickety structure".* (Vickers, 2011, p2)

- These are the opening remarks of the Chair of the UK Independent Commission on Banking looking at the Global Financial Crisis.

But was property at the heart of the solution?

- In the UK Independent Commission on Banking (ICB) interim report real estate is mentioned 5 times as a problem, but never in terms of solutions.
- In the ICB Final Report real estate is mentioned 7 times, but again does not feature in solutions (in Ireland over 250 times)
- Property *valuation* issues feature 0 times (in Ireland they discuss it 5 times)
- In Ireland they had a property person on the commission, in the UK they didn't.
- So not in 2011/12 – but in 2013 BOE taking an interest

And the UK property industry did have it on their radar

- "Vision for Real Estate Finance" draft report by the Cross Industry Real Estate Finance Group published by the Investment Property Forum in October 2013.
- Consultation leading to a final report in May 2014.
- Seven recommendations across three areas, :
  - Information, analysis and expertise (Recs 1-3).
  - Incentives (Recs 4-5)
  - A market structured for stability (Recs 6-7)

7 Recommendations

1. Loan database:
2. Expertise and insight for the regulator:
3. CRE finance qualifications:
4. Use of long-term value measures for risk management:
5. Better risk differentiation in regulatory capital requirements:
6. Encouraging diversity:
7. Regulatory governors, not switches, operating consistently across the cycle:

Recent Government Interest

- Financial Stability Group of the Bank of England have become much more engaged with CRE industry in relation to 2 of the recommendations.

1. Data base of loans transactions (Rec 1)
2. Long term value (Rec 4)

- It is the second of the two that I want to develop in this slot.

Bank of England Public Statements

1. Nurturing resilience to the financial cycle

- Speech given by Alex Brazier, Executive Director for Financial Stability Strategy and Risk, Member of the Financial Policy Committee at the Property Investor's Banquet, Mansion House, 19 October 2015.

> "So in a matter of months, the Bank of England will start reporting market-wide indicators of valuations and gearing based on cashflows capitalised at cycle-neutral rates."

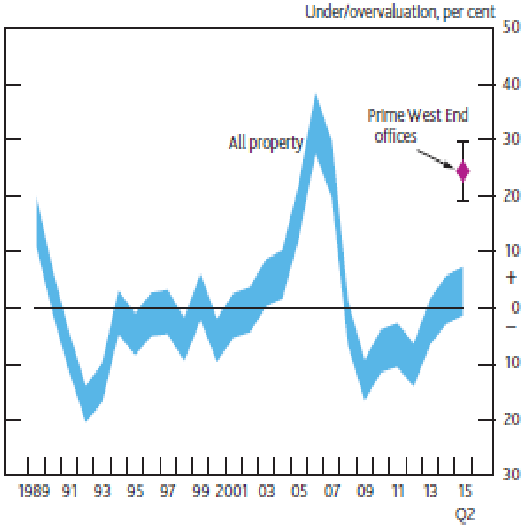
So what does this actually mean in valuation terms?

2. BOE Financial Stability Report Dec 2015, -

"a common industry approach is to consider a property's 'investment value'" (page 33)

Chart A.30 An investment valuation approach indicates some parts of the CRE market are overvalued

Extent of under/overvaluation of commercial real estate prices in the United Kingdom[a]



Sources: Association of Real Estate Funds (AREF), Bloomberg, Investment Property Forum, MSCI and Bank calculations.

(a) Investment valuations are based on assuming property is held for five years with the cash flows from the rent and sale discounted. It is assumed that the property is sold at a rental yield (in line with long-run averages fifteen years). The sale proceeds and rental income are discounted by the ten-year gilt yield plus a risk premium. The swathe represents varying assumptions on the average through the cycle risk premium, given the inherent uncertainty in measuring it; the lower end of the range is from a survey of investors from AREF and the higher end is a risk premium derived from the long-run relationship between gilt yields and property yields. For more details see Crosby, N and Hughes, C (2011), 'The basis of valuations for secured commercial property lending in the UK', *Journal of European Real Estate Research*, Vol. 4, No. 3, pages 225–42.

Currently Vision sub group now examining "Long Term Value"

- Why do we need one?
  - Counter the pro-cyclical lending behaviour associated with Market Value
- Is there actually such a thing as Long Term Value?
  - No, all valuations have no shelf life so they are all an estimate of the value at a particular date
- If not, what are the alternatives?
  - We can assess whether at any particular point in time markets are over or under priced

Current UK Initiative

- Three alternatives to MV currently being investigated by industry in the UK are:
  - Mortgage lending value
  - Investment value/economic fair value
  - Adjusted market value

Adjusted Market Value Methodology

- It is solely a backward trend fit to past data.
  - Establish Market “Real” Capital Values best fit Trend Line
  - Compare evolving trend line with Current Market Values
  - Identify time periods of Over and Under valuations
  - Easy to use at Market, Sector and Subsector level subject to data availability
  - Easy to accurately back test in UK: quarterly IPD data back to the early seventies and can also be applied to earlier data

Investment Value Methodology

- Discounted Cash Flow Approach
  - Five year Rental Forecasts
  - Exit at historic trend cap rate
  - Discount at Risk Free Rate plus Risk premium
  - Compare with Market Value to identify over or under valuations
  - Bespoke assumptions most useful at individual property level

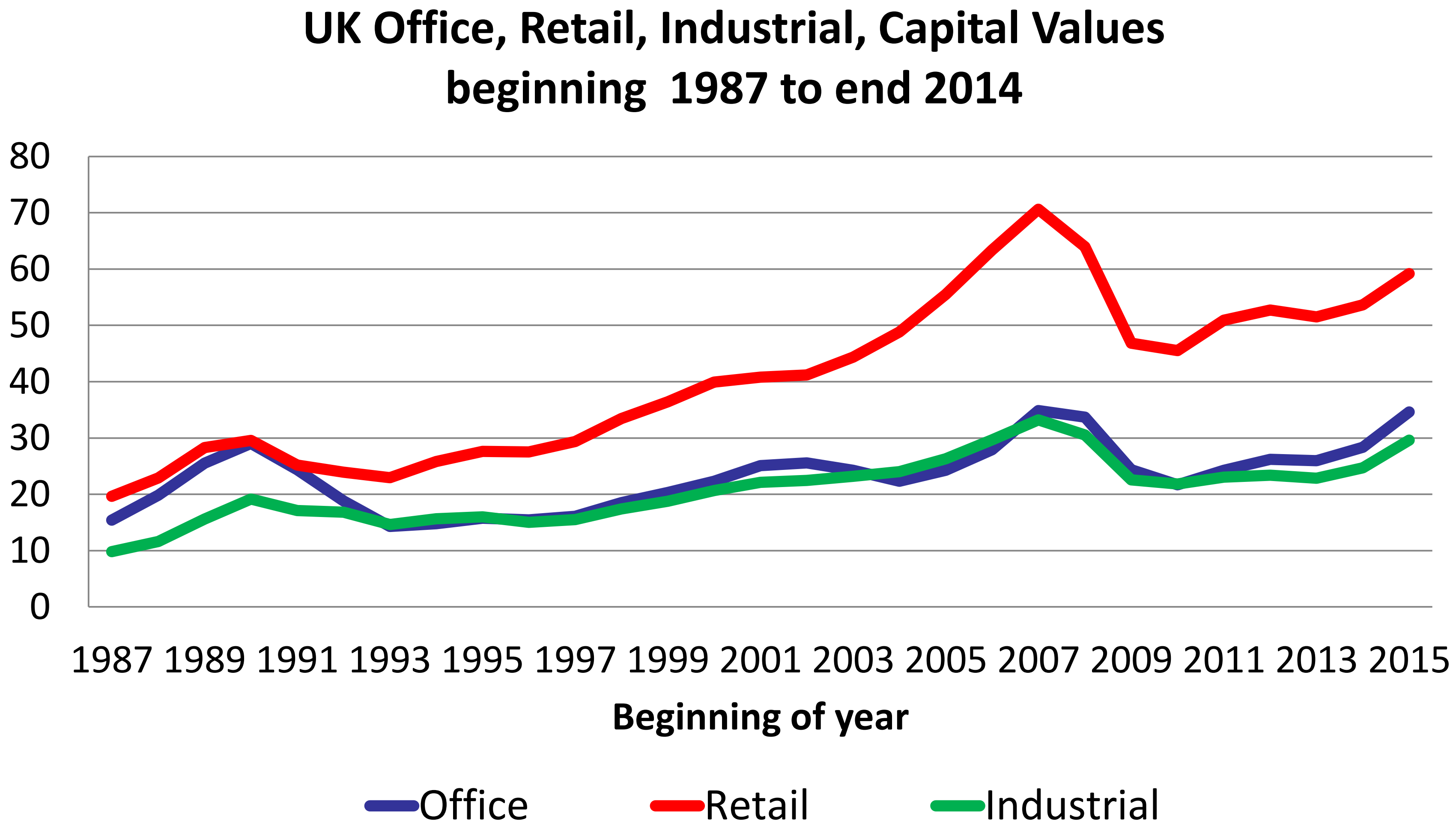
Mortgage Lending Value Methodology

- Intended to be very conservative assessment of value
- Based around historically conservative cap rates employing specified floors to that rate
- Ignores any market over-renting (sustainable rent?)
- Incorporates building depreciation rates by separating out land value from building value
- Most usually used at asset level
- Not intended to be used as a tracker for identifying significant **under**values – always less than MV
- Assumptions would have to be adjusted to reflect any overseas markets outside its natural home Germany

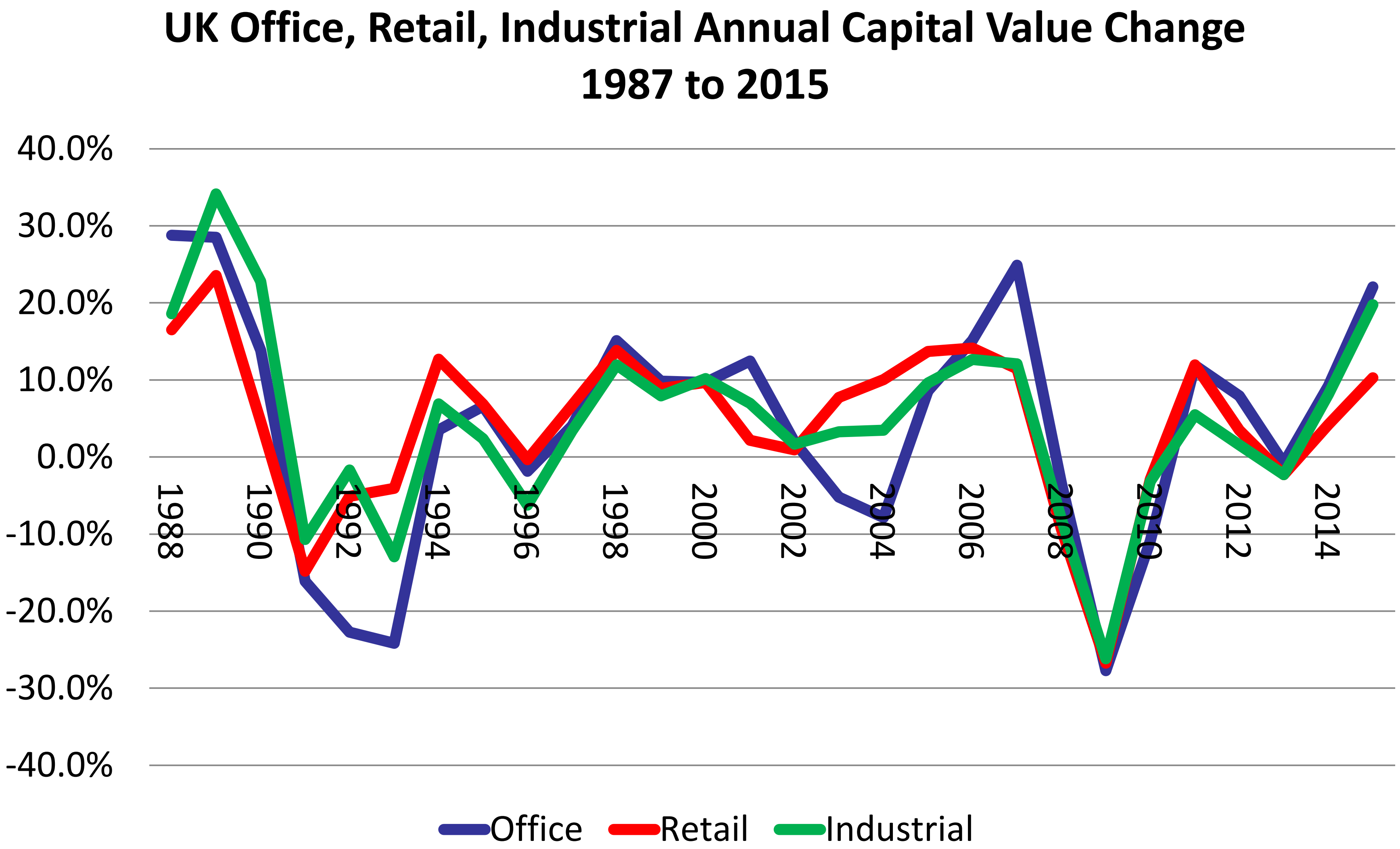
Modelling valuations through the cycles

- What would have been the impact of having each of the three valuation methods applied to UK property valuations in the last boom and bust - AMV, IV and MLV?
- Valuations of the three main UK market segments – Office, Retail, Industrial – End 1987 through to end 2014.
- No hindsight employed.

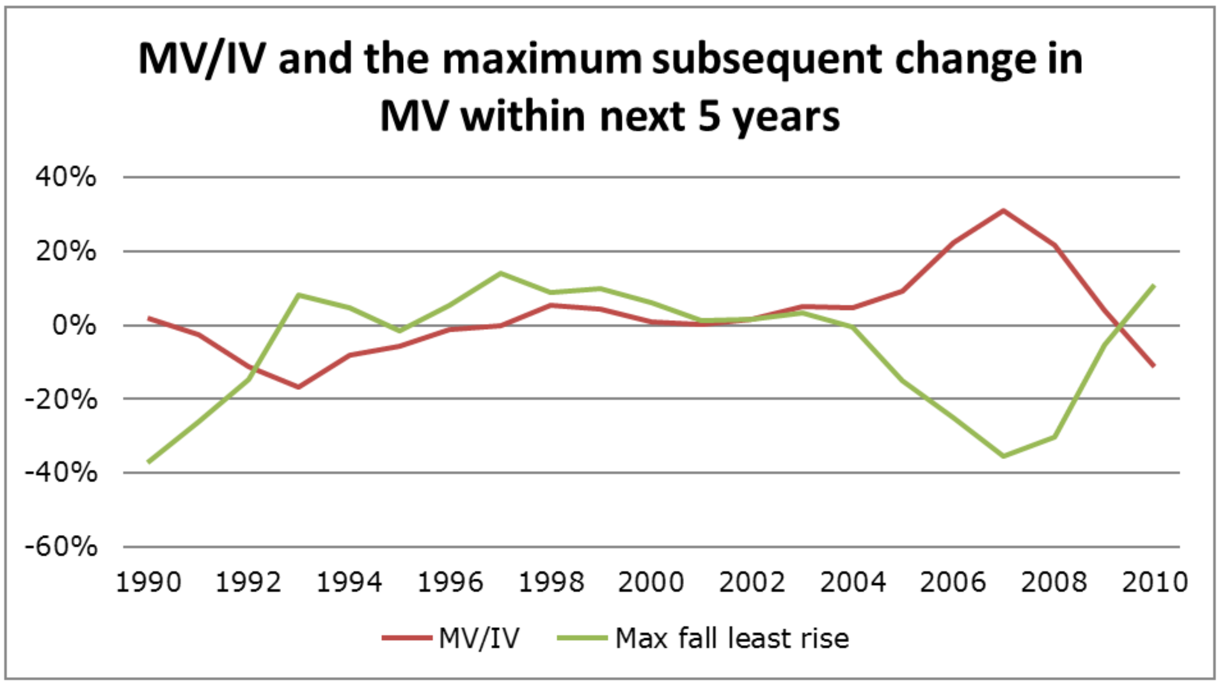
Market Values 1987 to 2015



Market Values 1987 to 2015

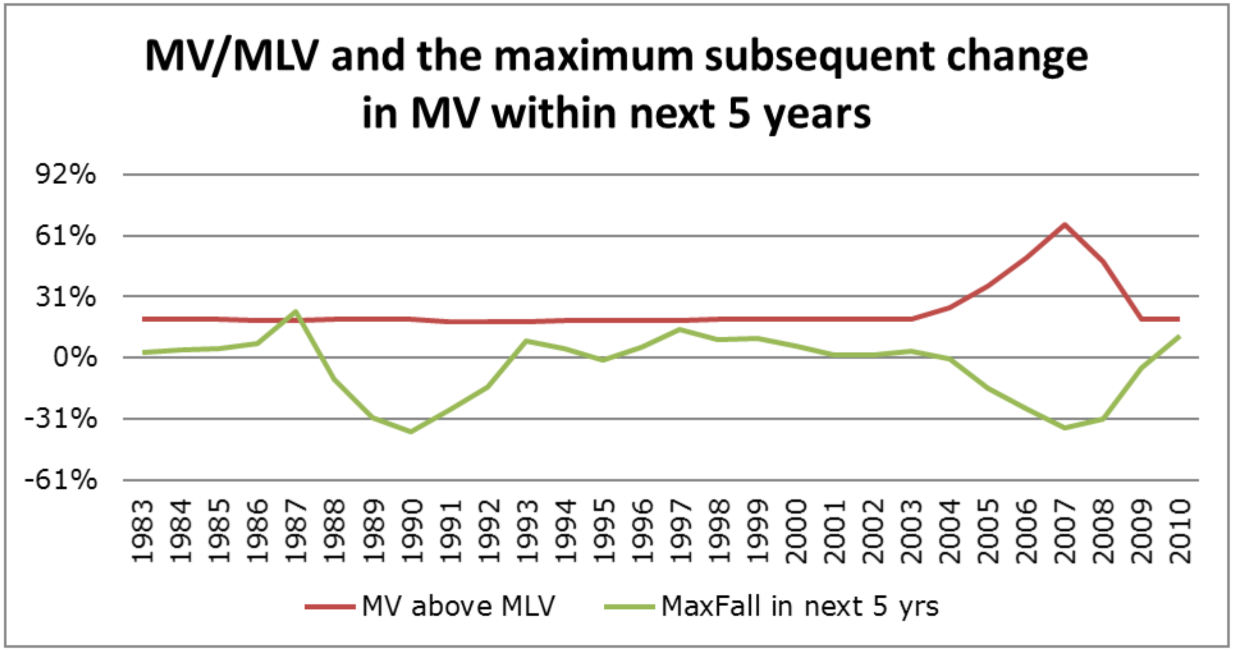


IPD All Prop. MV/IV value vs Max Fall Next Five Years



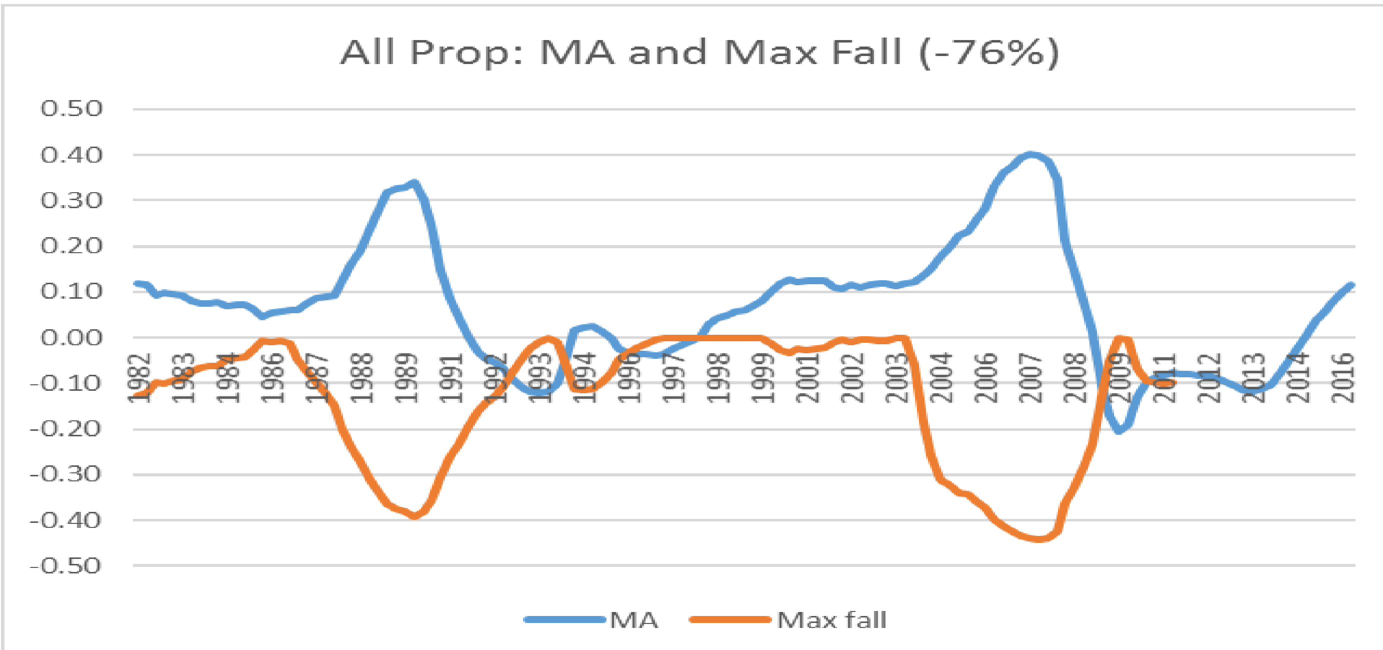
Missed 89/90 due to unrealistic Rental Growth Forecasts

MV/MLV vs Max Fall next 5 Years



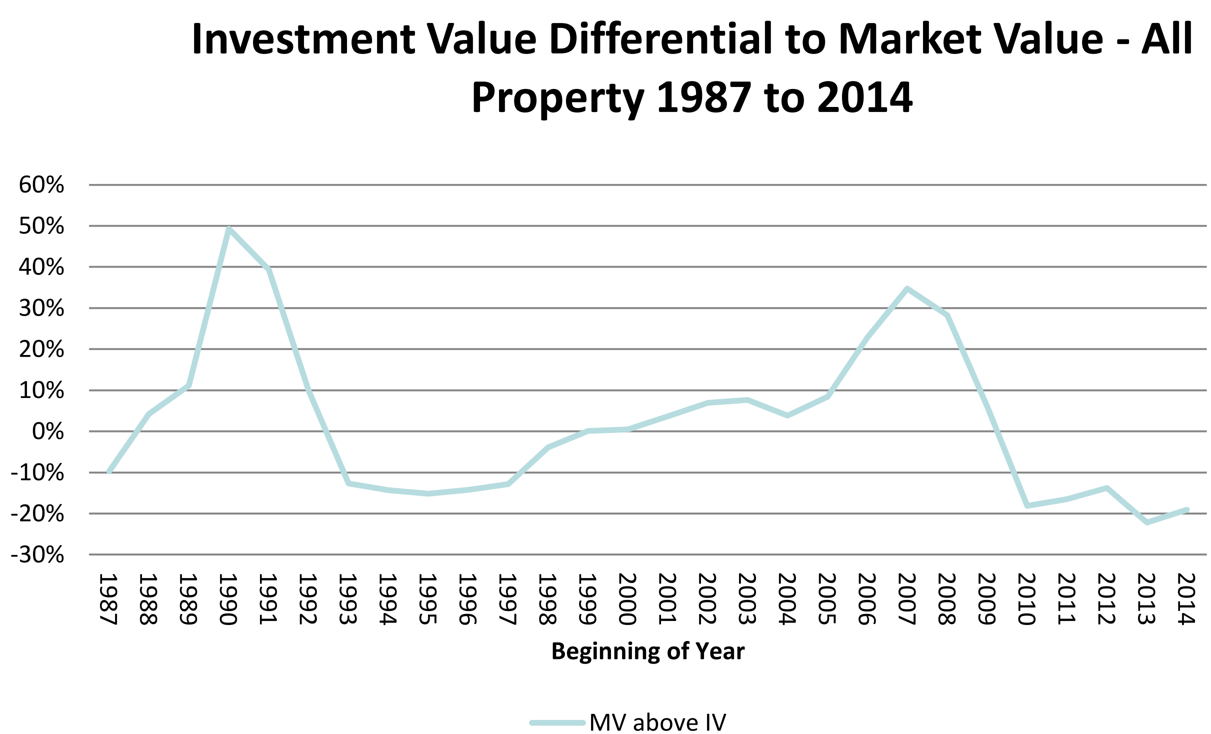
"Market" rental value assumption misses 89/90 crash

Comparing MV/AMV with Max Value Fall Over next Five Years



AMV accurately anticipated 89/90 and 07/08 crashes

IPD All Property MV/IV Using "Sustainable Rent"



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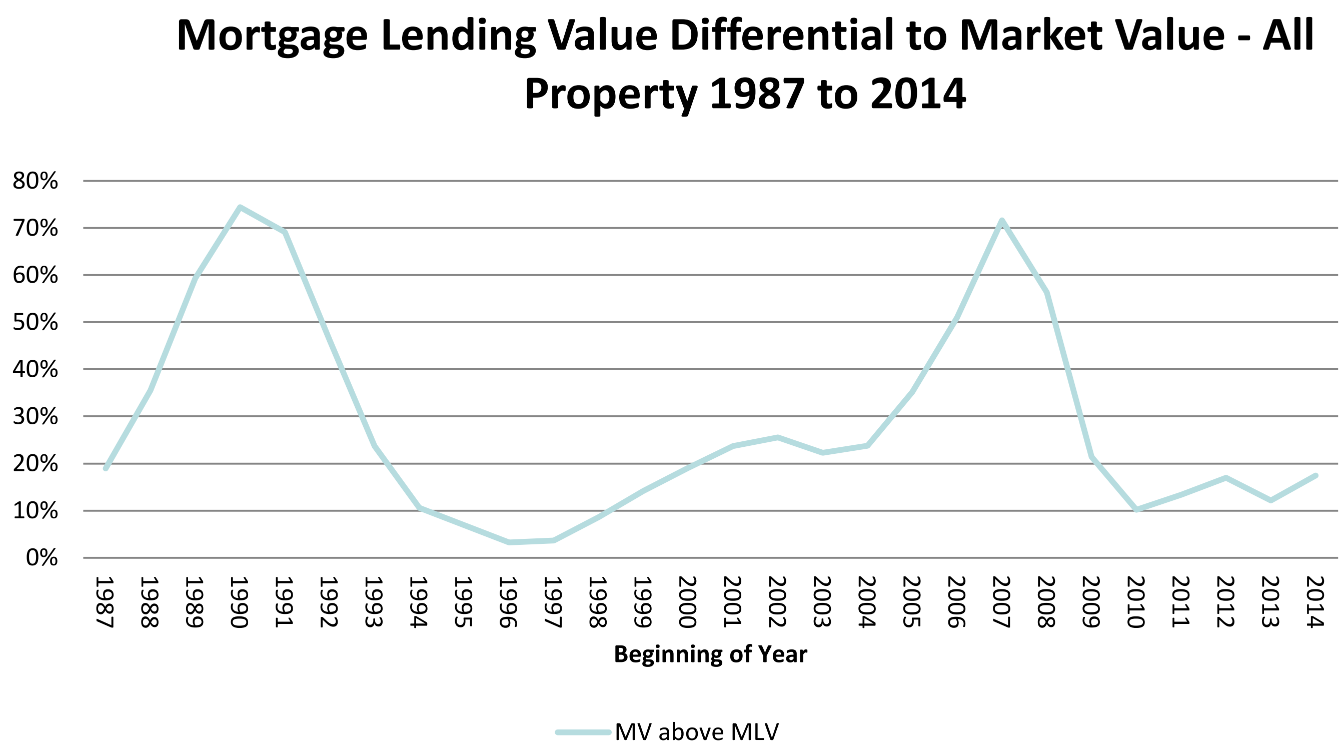
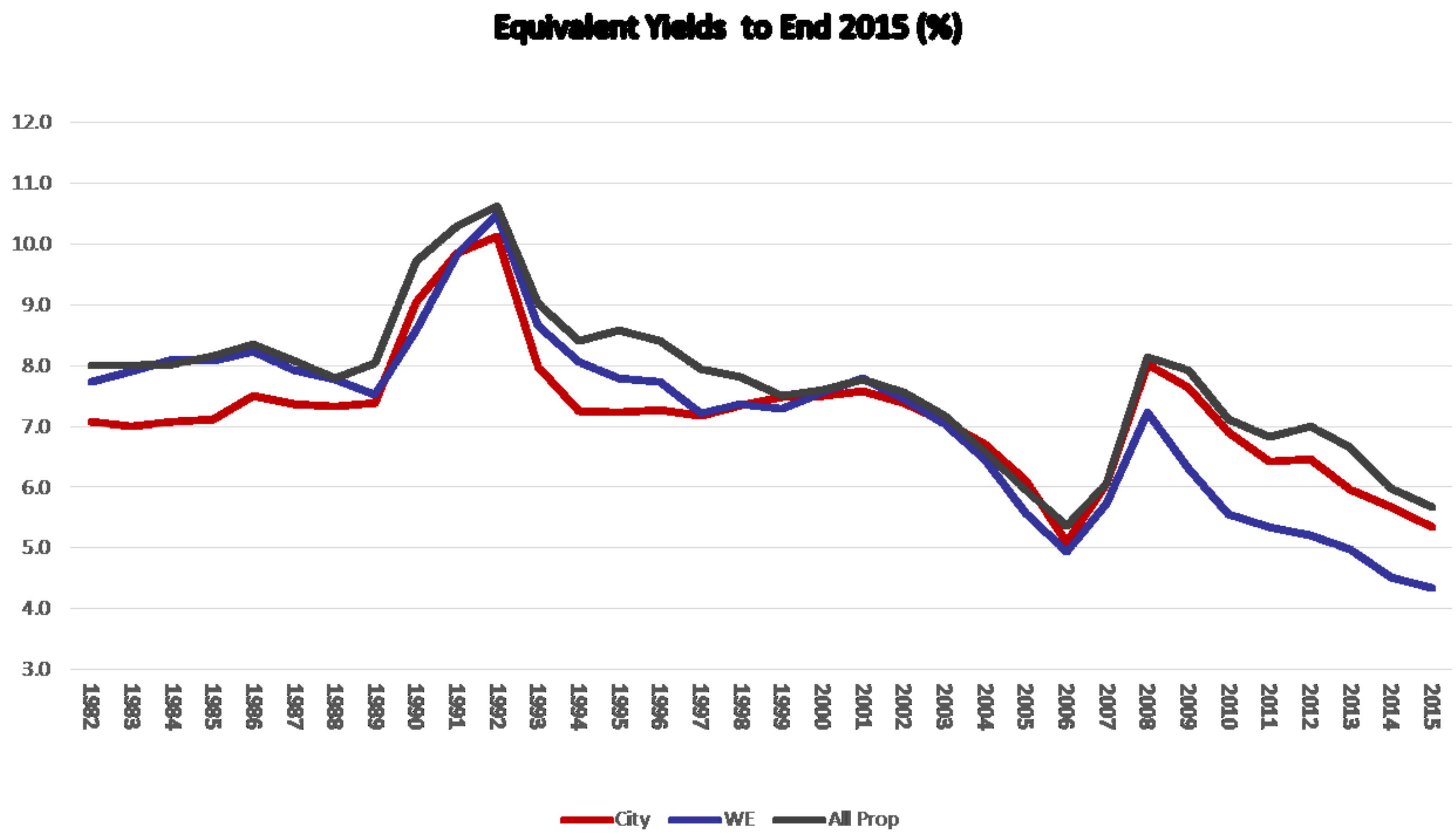


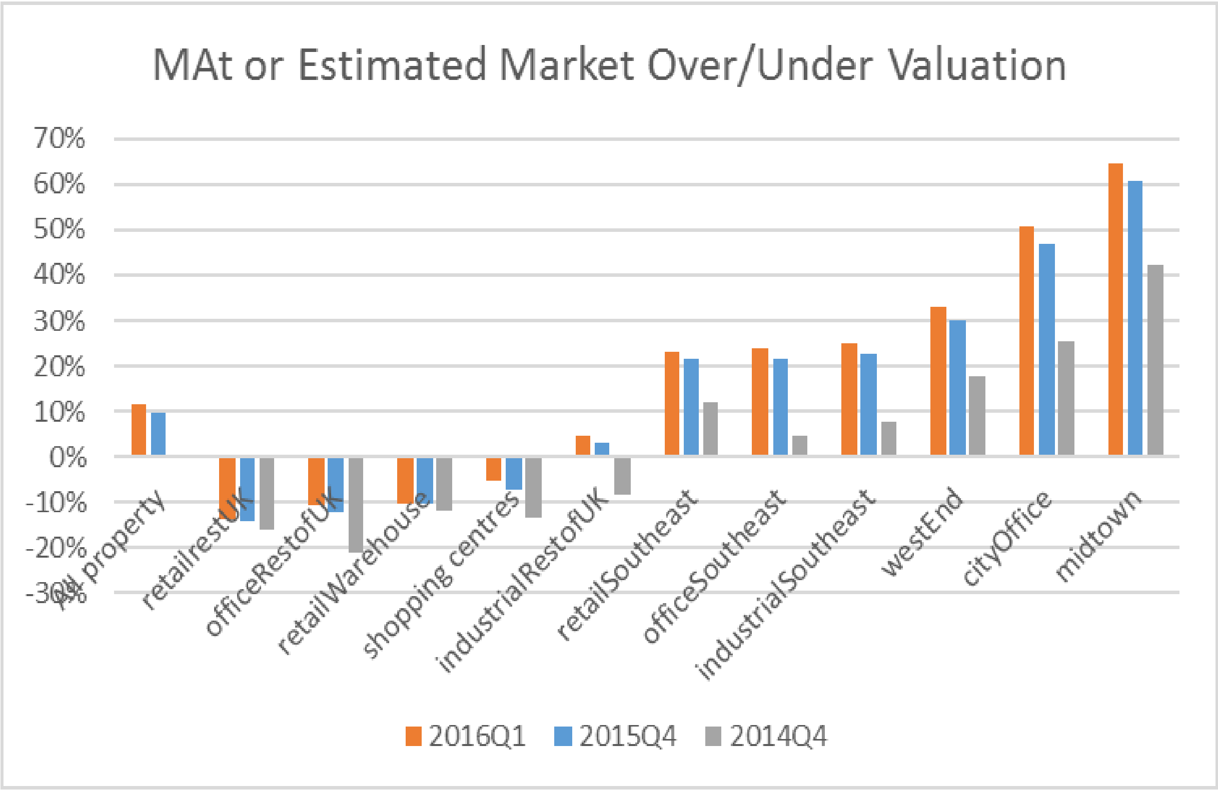
Summary

- BOE looking at fair economic values, UK industry investigating 3 models based on past trend analysis, future cash flow analysis and the more contrived German based MLV.
- Past trend would have identified the last two UK crashes even though one was an occupier market crash and the other was an asset market crash.
- MLV and IV need a sustainable rent concept or accurate forecasting respectively to work in an occupier market crash. All three models identified the 2007/08 crash.
- AMV works until you decide it is “different this time”?

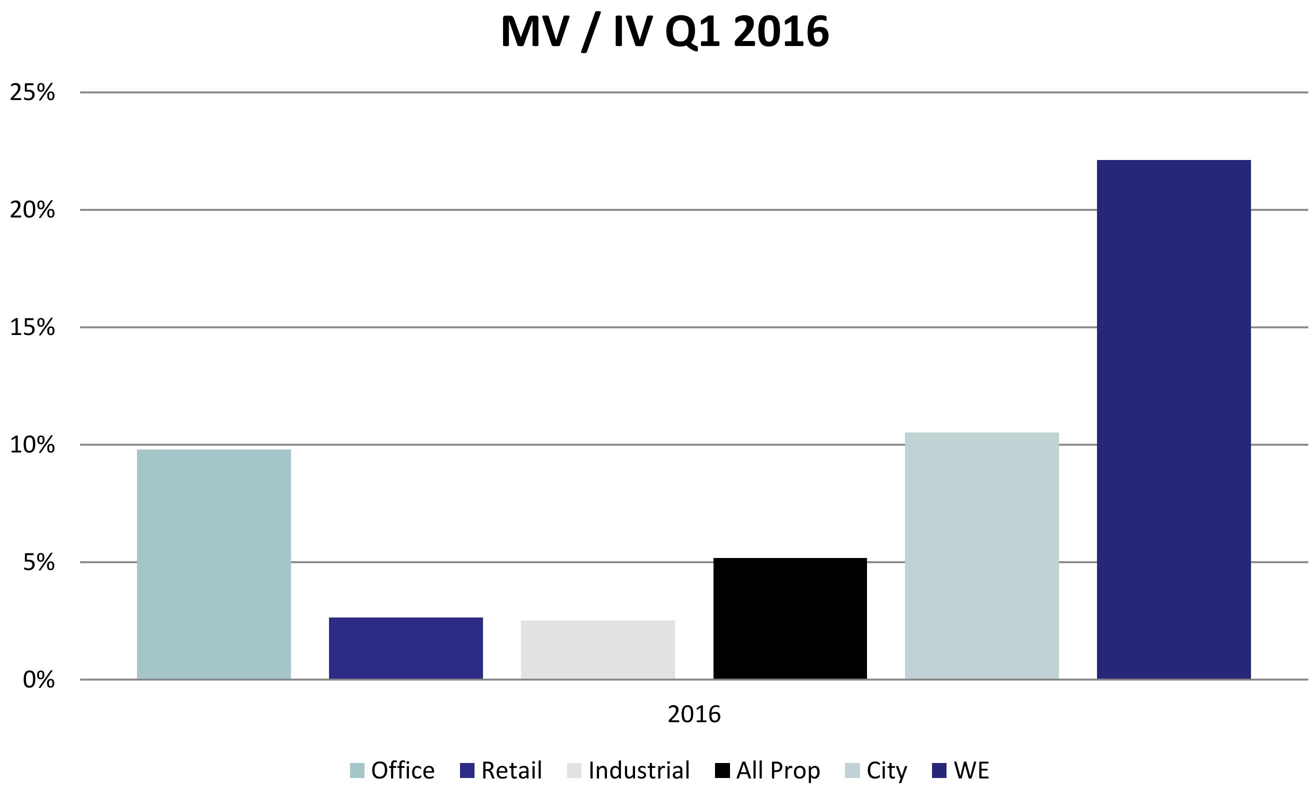
Equivalent Yields UK



MV/AMV in Current Market (Q1 2016)



MV/IV Overvaluations Q1 2016



Lowest Cap Rates Ever.
AMV says City 50% over priced and WE 30%
IV says City 10% over and West End 20% +
Which do you believe?