The mortgage lending value – Sustainability since 1900

TEN QUESTIONS AND ANSWERS

VERBAND DEUTSCHER PFANDBRIEFBANKEN
Association of German Pfandbrief Banks

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In recent years many international property markets have experienced phases of pronounced upward and downward movements. Distinct downward movements on the property market can have a negative impact on the entire economy of a country.

By international standards in particular, the German property market has shown itself to be stable over the last years and decades. There are many reasons why. One of the main reasons probably lies in the fact that, when granting a mortgage loan, German banks usually determine a mortgage lending value. The carefully determined mortgage lending value is one precondition for Pfandbrief Banks to be able to refinance property loans by issuing Mortgage Pfandbriefe. This possibility has proven increasingly important in the past months and years. There were phases in which Mortgage Pfandbriefe were the only capital market product with which property loans could be refinanced.

The concept of the mortgage lending value takes into consideration the long-term nature of the property loan in that, among other things, the determined mortgage lending value applies throughout the life of the loan – in most cases, therefore, for many years. This cannot be said of market values, which relate to a certain point in time. With the mortgage lending value, the main focus is on sustainability; economic fluctuations must be disregarded. In this way, it levels out exaggerations. At the same time, it is an important pillar of the safety of Mortgage Pfandbriefe.

The mortgage lending value has been used in Germany for decades, and is also being deployed for more and more cross-border property finance transactions. With this brochure we would like to give you a better understanding of the mortgage lending value and its specifications.

1. What is the mortgage lending value?

The mortgage lending value is the prudently calculated value of a property. It represents the value which throughout the entire life of the loan can probably be achieved for a property that is sold on the free market – irrespective of temporary (for example, economically-induced) value fluctuations in the respective property market. This requirement serves to eliminate speculative influences.

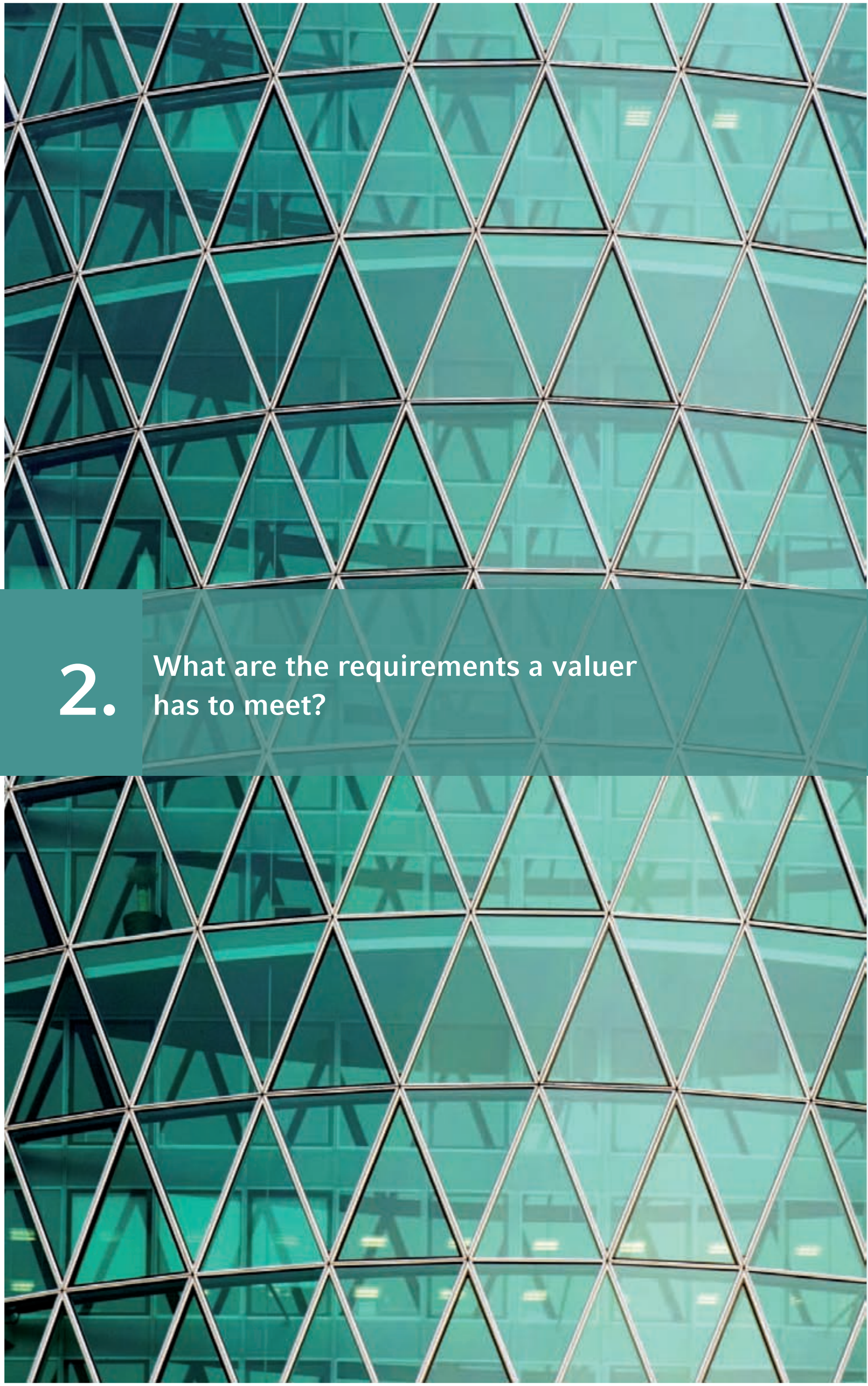
The mortgage lending value is a key element of the valuation of real estate as performed by the present-day Pfandbrief Banks and their predecessors, the German mortgage banks. When determining the mortgage lending value, the long-term, sustainable features of the property are taken into account, as are present and potential third-party uses and users. Because current – and possibly exaggerated – market prices have to be disregarded, the mortgage lending value has for decades now contributed to the stability of the German property market in particular.

The idea of the mortgage lending value dates back to the German Mortgage Banking Act, which entered into force in 1900, and the concept has been continuously refined ever since. The provisions governing the mortgage lending value were modernized when the Pfandbrief Act entered into force on July 19, 2005. The Regulation on the Determination of the Mortgage Lending Value (Beleihungswertermittlungsverordnung, BelWertV) of August 1, 2006, harmonized the requirements to be met by the methodology for determining the mortgage lending value and by the valuers who determine the mortgage lending value (see Question 2).

The determination of a mortgage lending value is required of, and accordingly is advantageous to, two groups of banks:

— (Pfandbrief) Banks that want to include real estate-secured loans – meaning loans secured by a land charge or mortgage – in the cover pool of a Mortgage Pfandbrief: Under sections 12 and 16 of the Pfandbrief Act, these banks must determine the mortgage lending value of the property in question. Not more than 60% of this mortgage lending value may be refinanced through the issuance of Mortgage Pfandbriefe.

— Banks seeking a privileged status for capital backing for real-estate secured loans: Here, the mortgage lending values of the properties lent against can serve as the basis for calculating such privileged status. If certain other conditions are fulfilled, the bank only needs to maintain a clearly reduced portion of capital for the part of the mortgage lending value up to 60%.



2. What are the requirements a valuer has to meet?

A mortgage lending value may only be determined by a suitably qualified valuer. The Pfandbrief Act and the BelWertV set stringent requirements with regard to a valuer's position and qualifications.

- Under section 7 of the BelWertV, valuers must be independent:
  - They must not be involved either in the loan transaction or in the sale, letting or brokering of property.
  - They must not be related to or have any other legal or business relationship with the borrower.
  - They must have no interests of their own in the outcome of their valuation report.

- Moreover, valuers must, again under section 7 of the BelWertV, be professionally independent. A Pfandbrief Bank may commission external valuers or employ valuers of its own. However, the latter must, within the scope of the bank's structural organization, be part of a unit of valuers which reports directly to the executive management; what is more, they must not have any involvement with divisions of the bank which are responsible for lending. In practice, such units of valuers are independent within the bank's organizational set-up in the same way as, for example, internal auditors.

- Under section 16 of the Pfandbrief Act and section 6 of the BelWertV, valuers must be experienced in property valuation and furnish proof that they have expert knowledge of determining mortgage lending values. Under the BelWertV, a valuer is assumed to be adequately qualified if he/she has been appointed or certified by a government body, a state-approved body or a body accredited according to the standard DIN EN ISO/IEC 17024 as appraiser or valuer for the valuation of properties. One such accredited body is HypZert GmbH. As at July 2011, there were 1,112 valuers who had been certified by HypZert.

- The requirements are less stringent for valuers who work solely in small loans for properties located in Germany (see Question 10).

3. What is the procedure when determining a mortgage lending value?

The determination of the mortgage lending value comprises three stages:

— Obtaining information
The valuer gathers information about the property and the respective property market. To do so, he consults official registers and other documents such as extracts from cadastres and land registers, property usage agreements, lists of tenants, plans as well as market data and market reports.

— Inspection
The valuer has to inspect the property to obtain, for example, a general picture of the condition of the building and the standard of the fixtures and fittings. Moreover, he/she checks for possible structural damage. The BelWertV provides for an exception from this requirement only where small loans for properties located in Germany are concerned (see Question 10).

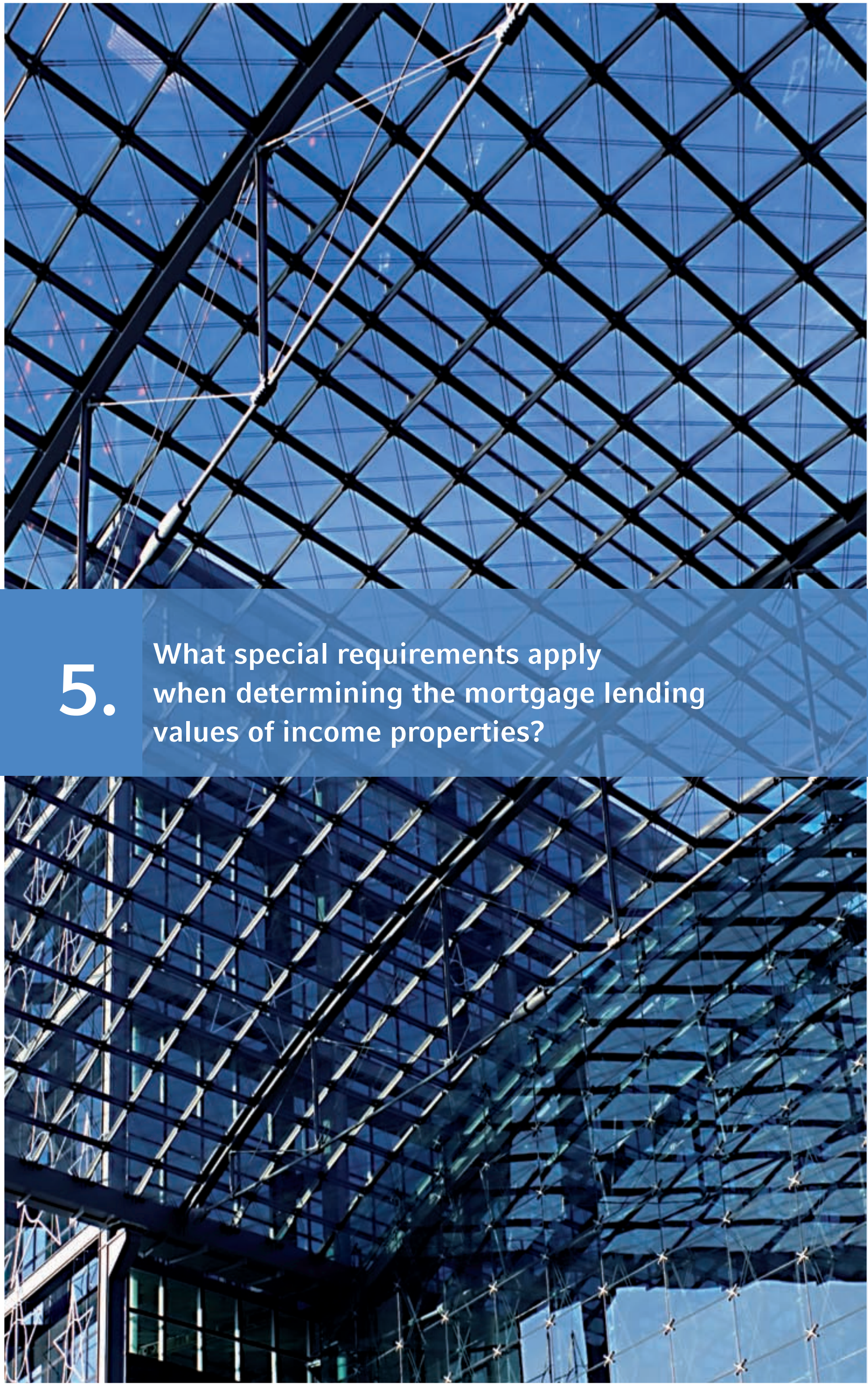
— Valuation including the valuer’s report
In the final stage, a valuation report is prepared. As well as an account of how the mortgage lending value of the property was determined, the report contains – in accordance with section 5 of the BelWertV – information about the property, the location and the regional property market as well as on the property’s usability and marketability.

4. What factors are taken into account when determining the mortgage lending value?

Section 3 of the BelWertV prescribes a “prudent” valuation.

The valuation must take into account
— the long-term, sustainable features of the property assuming normal regional market conditions,
— the use to which the property is currently put,
— the property’s marketability (i.e. potential alternative uses). Marketability in this sense answers the question whether the property would be suitable for types of use and/or users other than the current use and user or those originally envisaged.

The valuation must not take into account
— temporary (for instance, economically induced) fluctuations in value,
— speculative elements.



5. What special requirements apply when determining the mortgage lending values of income properties?

Income properties are properties from which the owner seeks to make a financial gain, for example by generating rental income. Such properties usually include office, retail and warehouse premises as well as hotels and multi-family dwellings. Owner-occupied residential buildings do not, as a rule, count as income properties.

With income properties, the calculation of the income value is of central importance when determining the mortgage lending value. Section 10 of the BelWertV stipulates that the income value must reflect only the income that the property is capable of yielding on a long-term, sustainable basis. This calculation produces the gross income.

Operating expenses must be subtracted from this gross income; these include management costs, maintenance costs, loss of rental income risk and modernization costs. An annex to the BelWertV stipulates bands for the individual cost items for each type of property. According to section 11 of the BelWertV, at least 15% must be deducted from the gross income by way of operating expenses.

Capitalization of gross income less operating expenses and the expected return on land then produces the income value of the building. Section 12 of the BelWertV also stipulates the capitalization rate. In the case of residential properties it must be at least 5% and at least 6% for commercially used properties (or in exceptional cases, i.e. prime commercial properties, at least 5.5%).

The income value of the property is then calculated by adding the income value of the building and the value of the land. For an example of this calculation, see Question 6.

6. What is the two-pillar principle?

With regard to income properties (see Question 5), the BelWertV requires that the valuer calculates the value according to the income approach (Ertragswertverfahren) as well as to the cost approach (Sachwertverfahren).

Because the purpose of income properties is to yield income, the property value calculated using the income approach is key when determining their mortgage lending values. If the depreciated replacement cost value of a property is more than 20% below the income value, however, the valuer is required to provide an explanation for that particular deviation or reduce the income value. This is regulated in section 4 of the BelWertV.

An example of this principle, known as the two-pillar principle, is shown on the next two pages.

EXAMPLE

Explanation of the two-pillar principle using as an example an office property (new building) in Anytown

FIRST PILLAR: INCOME APPROACH

Land value	
600 square meters à € 5,200 per square meter	€ 3,120,000
Gross income	
2,000 square meters of office space à € 30 per square meter and month sustainable rent	€ 720,000
15 underground parking spaces à € 110 per parking space and month	€ 19,800
Gross annual rent	**€ 739,800**
less operating expenses (costs that are not allocable to tenants)	
Management costs (3% of gross income)	€ 22,194
Maintenance costs	
Office space: € 15 per square meter	€ 30,000
Underground parking spaces à € 75 per space	€ 1,125
Loss of rental income risk (4% of gross income)	€ 29,592
Total operating expenses	**€ 82,911**
in % of gross income	11.2%
Minimum operating expenses according to BelWertV	15.0%
Stated operating expenses	**€ 110,970**
Net annual income	**€ 628,830**
Capitalization rate: 6.00%	
Expected return on land	**€ 187,200**
Net income of building	**€ 441,630**
Capitalization rate: 6.00%	
Remaining useful life: 60 years	
Multiplier: 16.16 (according to Annex IV to the BelWertV)	
Income value of the building	**€ 7,136,741**
Land value	**€ 3,120,000**
INCOME VALUE	**€ 10,256,741**
INCOME VALUE (rounded)	**€ 10,250,000**
Depreciated replacement cost value is ... % below the income value which is less than 20%, therefore	6.83%
MORTGAGE LENDING VALUE (income properties)	**€ 10,250,000**
Inclusion in cover (lending limit 60%)	**€ 6,150,000**

SECOND PILLAR: COST APPROACH

Land value	
600 square meters à € 5,200 per square meter	€ 3,120,000
Value of the building	
Building costs: 11,500 cubic meters à € 520 per cubic meter	€ 5,980,000
Depreciation (€ 0, as new building)	€ 0
Subtotal	**€ 5,980,000**
plus costs of the outside area (3%)	€ 179,400
Subtotal	**€ 6,159,400**
less safety margin pursuant to section 16 (2) BelWertV of 10%	€ 615,940
Subtotal	**€ 5,543,460**
plus incidental building costs pursuant to section 16 (3) BelWertV of 16%	€ 886,954
Value of the building	**€ 6,430,414**
Value of the building	**€ 6,430,414**
Land value	**€ 3,120,000**
DEPRECIATED REPLACEMENT COST VALUE	**€ 9,550,414**
DEPRECIATED REPLACEMENT COST VALUE (rounded)	**€ 9,550,000**

7. What is the mortgage lending value in relation to the market value?

The mortgage lending value and the market value are two different value concepts. They are calculated independently of one another using different methods.

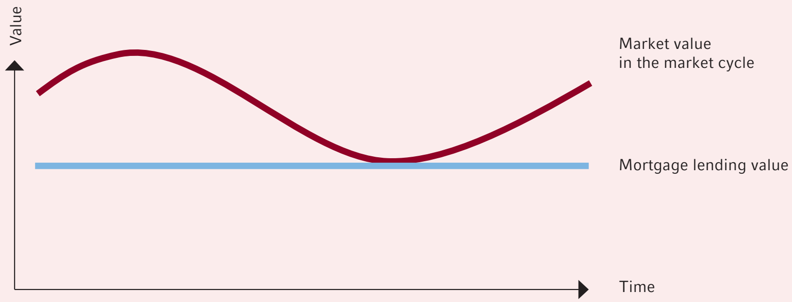
One fundamental difference is that the market value refers to a specific date. By contrast, the mortgage lending value must, according to section 3 of the BelWertV, apply "throughout the life of the lending" – normally for a period of many years.

As a rule, the mortgage lending value is well below the market value. Even in phases of a prolonged property market downturn – which is not to be reflected in the mortgage lending value as it constitutes an economic fluctuation – it must not, under section 16 of the Pfandbrief Act, exceed the respective market value. When applied properly, the rules of the BelWertV mean that the difference between market value and mortgage lending value of a specific property fluctuates very sharply. During recessive market phases in the past, the gap between mortgage lending and market value was very small. In boom phases, on the other hand, and especially in foreign sub-markets, mortgage lending values were in some cases more than 40% below the market value.

A simplified chart demonstrates this.

Mortgage lending value and market value in comparison

Valuation of a property by way of example



8. Does a different procedure apply when the mortgage lending value is determined for a property located outside Germany?

In principle, when determining the mortgage lending value it makes no difference in which country the property is located. However, Pfandbrief Banks may include a real estate-secured loan in the cover pool of Mortgage Pfandbriefe only if the property's location is in a member country of the EU or the EEA, Switzerland, the USA, Canada or Japan. This is stipulated by section 13 of the Pfandbrief Act.

Section 25 of the BelWertV sets forth the stringently defined preconditions under which country-specific (market value) reports may be referred to when determining the mortgage lending value of foreign properties. This section also states that such foreign reports do not take the place of a report in respect of the mortgage lending value; instead, they serve the valuer only as a source of information.

The easing measures for small loans (see Question 10) do not apply to loans secured by properties located outside of Germany.

9. How are the mortgage lending values of property portfolios determined?

In principle, the requirements contained in the BelWertV must be fulfilled for each individual property.

Only on rare occasions are exceptions made. This is true of highly homogeneous portfolios, which is to say in the case of properties which were all built in the same year and are in the same state of repair. Moreover, such properties must be situated on adjacent plots of land, as only then are they homogeneous in terms of their location.

10. What rules apply to the determination of the mortgage lending value in the case of small loans in Germany?

For standardized private housing finance in Germany, Section 24 of the BelWertV contains valuation-related easing measures. The aim is to make the lending process in this low-risk business area more efficient, without allowing the stringent principles governing the determination of the mortgage lending value to be breached. Essentially, these easements refer to the valuer’s qualifications and to exceptions regarding the property inspection requirement.

The decisive criterion in this respect is that the loan to be granted is below the limit for so-called small loans. This limit is the sum of the land charge plus all senior liens. Senior liens are rights and encumbrances entered in the land register which rank prior to the land charge to finance the purchase. If the total of the land charge and the values of these rights and encumbrances is less than 400,000 Euros, then the loan constitutes a “small loan”.

Below this limit it is possible for a person with the requisite expertise to prepare the report – provided that person is not responsible for the subsequent loan decision (segregation of functions with regard to preparing the report and granting the loan). The person in question must be sufficiently trained and qualified; his/her reports are examined by spot checks on a regular basis.

With small loans of this kind, the property inspection requirement may be dispensed with in individual cases. For instance, this is possible if the bank has inspected a similar apartment in the same building or a similar single-family house in the same housing estate in the previous two years. In the case of properties completed less than ten years before, the interior need not be inspected if the main valuation parameters are sufficiently well known.

You will find the complete wording of the Regulation on the Determination of the Mortgage Lending Value and of the Pfandbrief Act in an un-official translation in our Pfandbrief Act booklet. You can order it in hard copy via our website www.pfandbrief.org (under Publications – Order center) or download it as a pdf file.

Of course, this brochure can only provide you with an initial insight into the concept of the mortgage lending value. Should you have more detailed questions, please do not hesitate to contact the experts at our Head Office:

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