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Property Valuation requirements are changing under CRR3, with a new focus on models

Executive summary

The third amendment of the Capital Requirements Regulation[1] (CRR3) includes numerous updates to prudential requirements, however for banks with significant portfolios which hold immovable property as collateral, the updates to Articles 208 "Requirements for immovable property collateral" and Article 229 "Valuation principles for other eligible collateral under the IRB Approach" should be of particular interest.

These revisions include material changes to the criteria for monitoring property values and collateral valuation principles which are examined in this paper. These changes will result in significant additional data requirements for banks in addition to policy and procedural changes and governance impacts.

The impacts will materially affect first- and second-line teams involved in property transactions along with regulatory reporting teams. However, importantly, banks' model risk, model development and model validation professionals should also take note of the likely impact to their teams as CRR3 explicitly refers to a "model" for the first time in the context of property valuations. Additionally, and more broadly, senior management teams and the Boards of banks should be aware of and understand the regulatory changes and associated impacts within institutions.

Banks will see the impact of these articles in their internal capital requirements. CRR3 introduces risk sensitivity to the standardised approach for credit risk. Failure to effectively address the new monitoring and valuation requirements could see banks face higher risk weights, both for standardised exposures and IRB exposures (which will be subject to the standardised floor under CRR3).

1. Regulation (EU) 2024/1623 of the European parliament and of the council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor.

Introduction

Upon the introduction of CRR3, which is set to take to largely effect on the 1st of January 2025, various revisions and updates to prudential requirements will come into force. Some notable changes include enhanced robustness and risk sensitivity of the standardised approaches for credit risk, credit valuation adjustment (CVA) and operational risk. Some constraints to the use of internal model based (IRB) approaches will be put in place, by restricting the use of IRB for credit risk to certain portfolios and by removing the use of internally modelled approaches for CVA risk and operational risk. A leverage ratio buffer to further limit the leverage of global systemically important banks is also introduced. Additionally, the introduction of output floor requirements which specify the minimum capital requirements for banks relative to the capital requirements calculated under the standardised approach, will require banks using internal models to implement dual calculations under both the standardised and IRB approaches.

Among the most significant changes are seen in the requirements for Credit Risk. Key drivers of the changes described above for risk sensitivity and minimum capital requirements estimation are important amendments to articles relating to immovable property and collateral valuations, most notably in Article 208 and Article 229. The revisions to these two articles under CRR3 will result in significant challenges and uncertainty for banks. Changes will be required across people, process, and data.

On the people side banks will need to assess the capabilities and experiences of their independent valuers against the updated requirements. They will also need to ensure they have sufficient model development and validation capacity to undertake the new modelling requirements if they intend to leverage models for valuation monitoring.

Banks will need to identify which internal procedures will need to be amended or established. These will include updates to valuation policies and procedures and model development and validation standards. For example, for banks using external property price indices, it must be ensured that this meets the new criteria for models. It is essential that interpretation choices are subject to governance and oversight, rather than being left to implementation teams to perform in silos.

Description of new requirements:

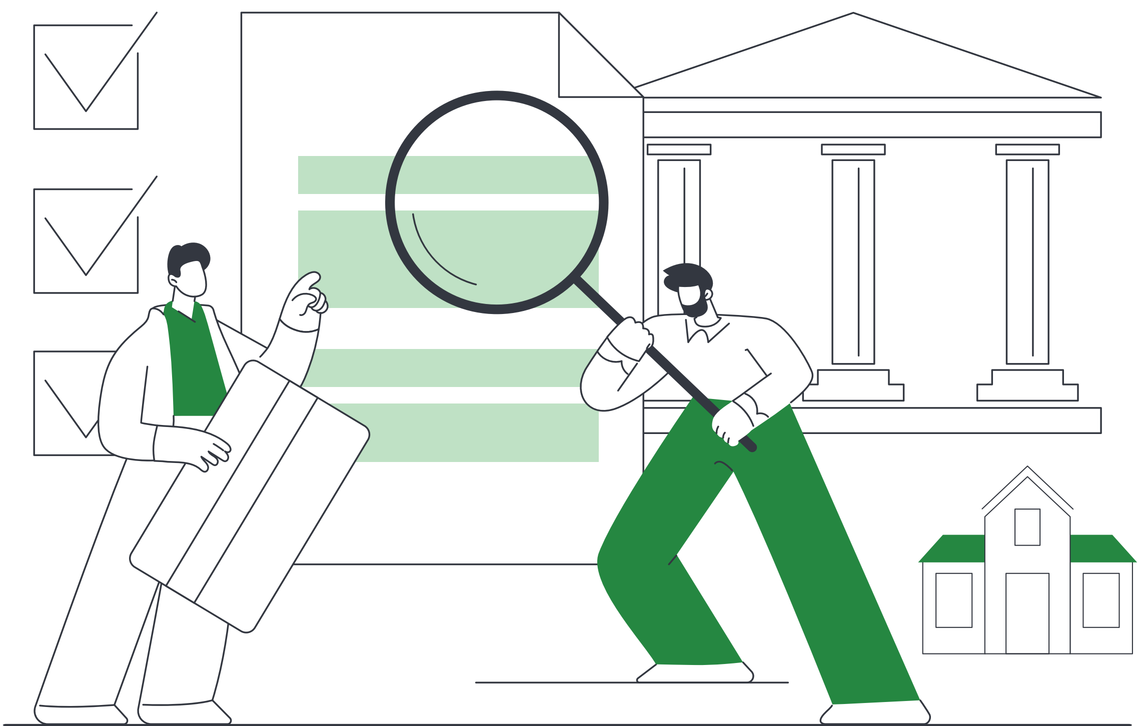
Banks with portfolios which hold immovable property as collateral, should place particular focus on the updates to existing Articles 208 "Requirements for immovable property collateral" and Article 229 "Valuation principles for other eligible collateral under the IRB Approach" under CRR3.

Significant revisions have been made to Article 208, which details the requirements for the monitoring of property values, and to Article 229 which is no longer restricted to eligible collateral under the IRB approach. The material revisions to both articles are summarised below.

Requirements for immovable property collateral – Article 208

Article 208 details the requirements for how banks should monitor property values. The existing requirement to review a valuation when information available indicates the value may have declined materially remains consistent, however CRR3 introduces a new explicit requirement to consider Environmental, Social and Governance (ESG) related legal and regulatory objectives as an indication that the value may have declined.

The incumbent regulation already provides for the use of statistical methods to monitor property values, however CRR3 includes a new paragraph, 208 (3a) which explicitly refers to a "model" first time, whereby the monitoring of a property value may be carried out by means of "advanced statistical or other mathematical methods ('models')".



The updated regulation permits the use of models provided the criteria for model use is detailed in banks' policies and procedures, which also account for the model's uncertainty. There are several other conditions which must be fulfilled, for example ensuring that the models used are property and location specific at a sufficient level of granularity; ensuring that models are valid and accurate, and subject to robust and regular back-testing, and ensuring models are based on a sufficiently large and representative sample and are based on up-to-date data of high quality.

Most notably the updated regulation requires that the estimates of models are independently validated, and the validation process is generally consistent with the principles set out in Article 185, where applicable. IRB banks will be familiar with this article which specifies the validation requirements for internal estimates and is contained in Chapter 3 (relating to the IRB approach) of Part III, Title II of the regulation.

Regardless of whether banks choose to manually monitor property values or to leverage models, internal monitoring procedures will need to be updated to align with the new ESG requirements.

IRB banks will have detailed policies and standards in place for model risk, model development and model validation. Banks who wish to leverage models for monitoring property values will need to complete a gap assessment to identify any additional criteria required by 208 (3) or otherwise standalone versions will be required.

Standardised banks that currently use models for purposes other than IRB will also have existing policies and standards in place for model risk, model development and model validation. These banks will also need to complete a gap assessment to identify any additional criteria required by 208 (3) or otherwise develop standalone/ new policies (where the do not currently exist). The changes required are likely to be more material for standardised banks and particularly in the case of Article 185.

Valuation principles for eligible collateral other than financial collateral – Article 229

There has been a small revision to the title of this article which has extended the scope of adherence for valuation principles beyond just collateral under the IRB approach to all eligible collateral other than financial collateral, unlike previously.

The updated provisions are more prescriptive on the requirements for the independent valuer who must possess "the necessary qualifications, ability and experience to execute a valuation".

While the incumbent regulation specifies that the valuation must be at or less than the market value, the update is more prescriptive on the prudency of valuation criteria. In future, values must both exclude expectations on price increases and be adjusted to account for the possibility that current market values are above what would be sustainable over the life of the loan.

CRR3 also introduces strict new requirements for the revaluation of property. Revaluations shall not exceed the average value of the property or a comparable property (over the last 6 years for residential or 8 years for commercial), or the value at origination, whichever is higher. The regulation also requires the average value calculation to include values which are observed at equal time intervals and to include at least 3 data points in the reference period. With a reference to Article 208(3) (described above) the regulation permits institutions to use the results of monitoring for the purpose of calculating the average value. Where modifications are made to the property that unequivocally increase its value, the valuation may exceed the average or origination value. Upward valuations are not permitted if institutions do not have sufficient data to calculate the average value except where the increase is due to modifications that unequivocally increase its value. Banks are likely to face challenges both in defining the modifications which will be classified as those which unequivocally increase the property value and having the data points to substantiate this.

The implications of the new rules mean that in markets where property prices are declining, if the value at origination is not available to banks, then valuations will be constrained to the (lower) average value. In markets where prices are increasing, where data are not available to calculate the average values, the valuation will be constrained to the (lower) value at origination.

A further interpretation challenge and cause of uncertainty for banks is that the regulation does not define the term comparable property. The EBA is mandated to draft regulatory technical standards to specify the criteria and factors to be considered for the assessment of the term "comparable property", however the deadline for this is within 36 months of CRR3 entering into force. Banks who wish to leverage the average value calculation will need to develop an interim internal definition.

An important point to note is the transitional arrangement (Article 495 (f)) by way of derogation from Article 229 (1a-c)) whereby institutions may continue to use the valuation principles from incumbent Article 229 (1) until a review of the property value is required in accordance with Article 208(3), or 31 December 2027, whichever is earlier.

Why is it important?

Fundamentally, when banks do not meet the monitoring criteria (either by individual monitoring or models that meet the new requirements), the property cannot be considered eligible collateral at all and the bank should treat the exposure as uncollateralised.

Another material impact of the above change will be to banks' internal capital requirements. CRR3 introduces risk sensitivity to the standardised approach for credit risk. Examples of this include a 20% risk weight for residential mortgages with Exposure to Value (ETV) up to 55% (Article 125 (1)) for non-IPRE[2] residential mortgages and incremental steps to Risk Weight %'s based on ETV for IPRE exposures (Article 125(2)). In cases where banks are unable to recognise valuations which are higher they may consequently be penalised by higher risk weights.

For IRB banks, CRR3 introduces a standardised floor relative to the capital requirements calculated under the standardised approach. Like above, banks that are unable to recognise higher valuations may be penalised by higher risk weights due to the higher standardised floor.

Identifying comparable properties for commercial properties may be particularly challenging in which case the value at origination may need to be used as the maximum valuation. Banks may use the results of monitoring to calculate the average values however where models are leveraged these models must meet the criteria set out in Article 208 (3).

Recommended Next Steps

The two articles discussed in this paper could result in some significant impacts for Irish banks which have large property portfolios. Banks should have a robust plan in place to adapt to these rules from a people, process and data perspective and consider accelerating some existing processes where there is a derogation to the new rules. As with all changes arising from CRR3, banks should ensure that all relevant stakeholders recognise and understand the obligations, thus ensuring an appropriately holistic response to this material regulatory change.

Banks will need access to new types of data to meet the ESG requirements. Additionally, it is likely that additional data will be required for monitoring property values and to identify comparable properties, which is likely to be particularly difficult for Commercial properties.

Banks who intend to leverage models should assess how they intend to operationalise the new requirements in relation to these.

Banks should consider the likely impact of both the new rules and the derogation. Updating valuations prior to year-end 2024 would buy some additional time in the cases where prices are not falling. In an increasing market obtaining frequent valuations could also benefit the banks with a reduced ETV and RW%.

From a governance perspective, the regulatory changes emerging from CRR3 must be recognised and understood, at the appropriate level, by relevant stakeholders across the three lines of defence, as well as at a senior management and Board level.

2. Income Producing Real Estate

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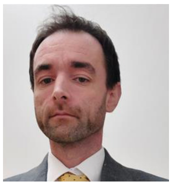

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