“Mortgage lending – Its relationship with Property Valuation”

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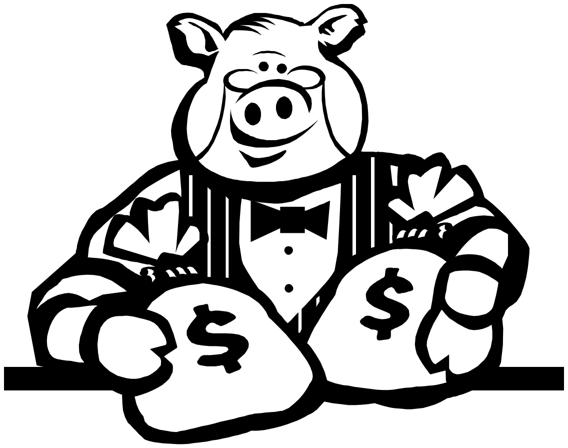
Introduction.

The act of valuing real property has had a direct and critical relationship to mortgage lending. While the act of valuing is considered an art not a science. The need to have a valuation that supports market transactions has been a critical part of many banks lending practices.

Lenders and valuers have always shared a common bond and although sometimes tested, lenders have seen valuations as a requirement to prudent lending practices.

Mortgage valuation standards have been extensively developed to assist lenders to be better and fully informed when taking out a mortgage or lien over real property.

The relationship.



To much of this can result in….

Lenders and valuers should form strong partnerships based on trust and skill

Why have a mortgage valuation standard?

The objective of International Valuation Application 2 (IVA 2) is to provide a framework for valuations of assets that are to be offered or taken as loan security.

Therefore having regard Valuers consistently apply accepted valuation principles.

Valuers apply:

Standards to support clear, independent and objective opinions

that are relevant to the needs of valuation users.

Definitions.

Mortgage. A pledge of an interest in property as security or collateral for repayment of a loan with provision for redemption on repayment. In the event the borrower (mortgagor) defaults, the lender (mortgagee) has the power to recover the property pledged.

Market Value. The estimated amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion (International valuation standard 1, para. 3.1).

Source: Savills Research & Consultancy, Q1 2010

The relationship: Lender and Valuers

The relationship between lender and valuer has been crated by the facility to lend money or as the definition sates the act of a loan repayment.

Can banks report on value? Practically and theoretically NO.

The bank does not hold the skill or knowledge and a valuer is generally a respected qualification greater than that of a real estate agent or broker.

Valuers in many counties hold a certificate of registration with some countries now enforcing a degree status to become registered.

Banks also set minimum years of experience to undertake certain valuation exercises.

The Act of Valuing.

Valuations for loan security frequently require valuations that assume a change in the current state or condition of the property, for example in situations where the lending is for development of a new building.

Should banks also play the role of the valuer? Practically and at law, NO.

The bank needs an independent assessment of value so that the validity of the outcome is not tainted by bias either way or for what ever reason. Independence and confidentiality has always been the valuers primary objective and is always cast in stone.

The Valuer.

Valuers should be aware of the risk associated with valuations for lending institutions both main stream and more particular secondary or mezzanine lenders.

Where the valuer does not understand the instruction and an error occurs this may lead to a dispute or even litigation between the lender and the Valuer. For example, in the event of a default by a borrower, the lender may sell a property after foreclosure or under a mortgagee in possession and realise less than the valuation.

The valuer must apply the best method of valuation and is required to have the expertise and skill required to make this judgment. The valuer is to apply all standards.

The valuer must provide Market Value each time and disclose any adverse effects that may impact on value fro the purpose of a loan.

The Lender. 

The lender is required to provide clear and defined instructions to the valuer.

Major banks and other lenders are normally subject to regulations that limit the total amount they can lend as a proportion of the lenders’ assets, known as the solvency ratio. In the international context, the Basle II Accord sets out rules for the minimum solvency ratios to be maintained by lenders and how those ratios are to be calculated. The value of assets over which the lender holds security is used in calculating the solvency ratio.

Apply prudent lending practices and have full and frank disclosure with their valuers.

Disclosure Requirements.

In reporting Market Value for lending security purposes, the Valuer shall make all disclosures required under IVS 3, Valuation Reporting.

The basis of the Valuers engagement is to be clearly set out in any reports to be used by third parties.

All reports should be presented in a way that would not be considered by a reasonable person to be misleading.

The Valuer shall disclose the regulatory framework and any departure required from these Standards to comply with local legislation, regulation, or custom.

Investment Properties.

Income-producing properties are usually valued as individual properties. Lending institutions may also wish to have a property assessed as part of a portfolio of properties.

Although the Valuer should comment on the expected demand and marketability of the property over the life of the loan, it is normally outside the scope of the valuation exercise to advise on the ability of a tenant to meet future lease obligations beyond comment on the market's current perception of the tenant's quality.

In such instances, the distinction between the value of the individual property, assuming it is sold individually, and its value as part of the portfolio should be clearly expressed.

Owner-Occupied Properties

Owner-occupied properties valued for lending purposes will normally be valued on the assumption that the property is transferred unencumbered by the owner's occupancy, i.e., that the buyer is entitled to full legal control and possession.

This does not preclude consideration of the existing owner as part of the market, but it does require that any special advantage attributable to the owner's occupancy, which may be reflected in a valuation of the business, be excluded from the valuation.

Leases Between Related or Connected Parties

Caution is required where property offered as security is subject to a lease to a party connected to the borrower. If the valuer considers that the lease creates a more favourable income stream than would be obtainable on a letting to an unconnected third party in an arm’s-length transaction, the lender should be alerted and it may be appropriate to disregard the existence of the lease in a valuation of the property as security.

AUSNZ 6.7.2 Leases Between Related or Connected Parties

In Australia and New Zealand if the valuer considers that the lease creates a more favourable income stream than would be obtainable on a letting to an unconnected third party in an arm’s-length transaction, the lender should be alerted and it is appropriate to disregard the existence of the lease in a valuation of the property as security.

Sales Incentives.

It is not uncommon for a seller of property, especially developers of real property, to offer incentives to buyers.

Examples of such incentives include rental income guarantees, contributions to the buyer’s removal or fitting out costs, or the supply of personal property such as furnishings or equipment.

Market Value ignores any price inflated by special considerations or concessions. It may also be appropriate to alert the lender as to the effect that any incentives being offered have on the actual selling prices achieved.

Specialised Properties

Specialised properties by definition may have limited marketability and significant value only as part of a business for loan security purposes, such properties will normally be valued on a vacant possession basis and a valuation based on the highest and best alternative use is usually applicable. This will involve consideration of the costs and risks that would be involved in achieving that use. Lenders may not consider specialised property to be suitable as a security for lending purposes.

A valuation may be required of a specialised property where the property is part of a going concern business. The lender should be alerted to the valuation being dependent on the continuing profitability (or otherwise) of the going concern. If the value on a vacant possession basis is potentially lower, this should be drawn to the attention of the lender

Forced Sales and Limited Marketing or Disposal Periods

Lending institutions may request valuations on a forced, or liquidation, sale basis or impose a time limit for disposal of the security. Because the impact of a constraint on the price obtainable will depend upon the specific circumstances under which the sale takes place, it is not realistic for the Valuer to speculate on a price that could be obtained without either knowledge of the reasons for the constraint, or the circumstances under which the property might be offered for sale.

An alternative valuation may be provided based on defined assumptions, but the Valuer should draw the lender’s attention to the fact that this opinion is valid only at the valuation date, and may not be relied upon in the event of a future default, when both market conditions and the sale circumstances may be different.

New concept:

Mortgage Lending Value is a long-term, risk assessment technique. As such, it is not a basis of value. MLV is a technique that is primarily used by banks in a number of European countries.

Mortgage Lending Value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account the long term sustainable aspects of the property, the normal and local market conditions, as well as the current use and alternative possible uses of the property.

Speculative elements should not be taken into account in the assessment of Mortgage Lending Value. Mortgage Lending Value should be documented in a clear and transparent way.

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