EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Supervision Newsletter

14 August 2024

Commercial real estate valuations: insights from on-site inspections

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For several years in a row, supervisors have been working towards addressing structural deficiencies in banks' credit risk management frameworks. The ongoing market downturn for commercial real estate (CRE) warrants particular attention, as it could have knock-on effects on the asset quality of some banks. With higher interest rates and lower demand weighing on key segments, borrowers are more likely to face debt servicing challenges. Robust collateral valuation is therefore highly important.

Since 2018 the ECB has been conducting an on-site inspection campaign to examine the CRE exposures[1] of systemically important banks.

Given the importance of valuations in assessing a bank's risk management framework, especially for interest-only loans, the campaign has drawn on the expertise of qualified and experienced valuers to review a sample of banks' valuations. The valuations reviewed cover many regions of the world, including the United Kingdom and North America.

The inspection teams have found a range of problems in how banks commission or carry out valuations.

This article presents the common issues that were observed during the campaign and highlights good practices that banks can adopt to improve the collateral valuations in their CRE portfolio.

Getting the basics right: market value

Market value is the basis of value specified for immoveable property collateral in the Capital Requirements Regulation (CRR), yet it is frequently misunderstood or wrongly applied.

[1] The campaign adopts the European Systemic Risk Board's definition of CRE, which covers all income-producing real estate, including rental housing, and real estate used by the owners for conducting their business, either existing or under construction. It covers the lending portfolio and, when relevant, properties directly held on the balance sheet.

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The current CRR and the ECB's Asset Quality Review (AQR) manual both require real estate assets held as collateral to be measured at market value. Article 229 of the CRR states that "the market value is the estimated amount for which the property would exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction". The AQR uses the full definition of market value appearing in the International Valuation Standards (IVS):

> "…the estimated amount for which an asset or liability should be exchanged on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion."

In financial reporting, for example for measuring the value of an asset or liability represented by a loan or for measuring a CRE asset held directly, the asset's "fair value" is required. Although the fair value definition in International Financial Reporting Standards (IFRS) 13 differs from the IVS definition of market value, the outcome for non-financial assets should be the same if each value is correctly applied in accordance with its supporting standards. While the rest of this article only refers to market value, the points made apply equally to fair value under the IFRS.

Frequent misconceptions about market value

The inspection teams have frequently found these definitions being misapplied, leading to incorrect reporting figures. Some examples include:

- Following a default, some banks interpret market value as being the figure that they would expect to achieve when they are actually in a position to sell, which could take months or even years in the event of disputes with the borrower or adverse possession. However, market value assumes a sale does take place on the reporting date, and that the achievable price would reflect all the issues that mean the bank cannot, or prefers not to, sell on that date.
- The same issue arises with respect to market downturns. Sellers prefer to wait until values recover, and more buyers are unwilling or unable to commit to new purchases until it is clear prices are no longer falling. However, market value requires a hypothetical sale to be taking place on the reference date. Values have to be based on the market reality at the time, not on a previous date when conditions were more favourable or on what might be hoped for in the future when the market improves.
- Some banks adopt what they consider to be a "through-the-cycle" value by reducing the market value at inception if the market is strong. Certain banks used this as an argument for not writing down values in the recent downturn. However, this does not remove the need to

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monitor actual market values if the market deteriorates over the term of the loan because there are currently no models that can reliably predict future values for a specific property.

Proper marketing period – irrelevant to the reported value, but an important risk consideration

According to the market value definition, the price is agreed after "proper marketing". The IVS conceptual framework makes clear that there is no fixed period to allow for proper marketing as this will vary according to the type of asset and market conditions. The only criterion is that there must have been sufficient time to allow the asset to be brought to the attention of an adequate number of market participants and that they be given time to undertake appropriate due diligence.

Market value is not a projection of the price that would be achieved at the end of a "proper marketing period" starting on the reporting date. The proper marketing period is deemed to have occurred before the valuation date so the actual length is irrelevant to the value reported.[2] However, lenders should normally ask the valuer to provide an estimate of the proper marketing period as it provides an indication of the asset's liquidity, which is an important risk consideration. This information could be significant when determining the individual provisions for non-performing loans, especially with respect to the time to sell considerations. It could also be considered when determining the market price discounts for the fair value of immovable property held for sale under IFRS 5.

"Highest and best use" does not equate to the highest achievable price

There were many examples involving development projects where the concept of "highest and best use" was wrongly used to inflate market values. The IVS conceptual framework explains that market value reflects the "highest and best use", but this does not mean that it is the highest possible price that could be achieved. It merely confirms that a seller acting in their best interest will seek to maximise the price and a buyer acting in their best interest will not pay more than is justified by the facts prevailing on the valuation date. An informed buyer acting prudently will not speculate on uses which are currently not technically possible, legally permissible or financially feasible.

Lenders should therefore ensure that they and their valuers fully understand and apply the detailed commentary on the application of market value (IVS) [3] and fair value (IFRS 13).

[2] It is also important to note that asking for a value that can be expected at the end of an adequate marketing period will be of little assistance if market conditions change over that period.

[3] IVS 2025 – 102 A10 and A20.

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CRR III will provide further detail on valuation principles for immovable property collateral

With effect from 1 January 2025, Article 229 of the CRR indicates that the “value” of immoveable property collateral must still be appraised by an independent valuer, while also specifying additional requirements, such as:

- the value must exclude expectations of price increases;
- the value is adjusted for the potential for the current market value to be significantly above the value that would be sustainable over the life of the loan;
- the value is not higher than the market value (where this can be determined).

This change does not imply that a completely new valuation approach is needed, but it does introduce key new requirements to ensure a prudent and conservative value assessment. The requirement for an independently determined market value remains. Article 208 of the CRR requires lending institutions to maintain data on markets as part of their risk weighting process and to monitor property values to determine if they have materially declined compared with general market prices. The revised wording of Article 229 of the CRR effectively indicates that these data should be used to consider whether the market value should be subject to a haircut

Comparable evidence should be validated

Most common shortcomings:

- *using outdated or inappropriate market data*
- *ignoring current market sentiment and expectations of market participants*

All valuation methods use data (evidence) from actual transactions that are comparable to the hypothetical transaction in the market value definition, such as price per square metre, building costs and discount rates. A problem arises in a downturn when transactions become less frequent or come to a halt.

During the second half of 2022 and throughout 2023, the inspection teams found cases where banks or their valuers were relying on transactional evidence from 2021 or earlier. No adjustment was made to reflect the market downturn and the very different economic circumstances, not least the increase in inflation and in ECB interest rates from 0.25% to 4.5% over this period. Banks argued that without more recent transactional evidence, there was no evidence that the market value had fallen. This overlooks the fundamental principle that the market value hypothesis requires there to have been parties willing and able to enter into a transaction on the reference date, being knowledgeable of the market conditions.

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Consequently, all inputs based on historic transactions must be adjusted to reflect changes in the market over the intervening period.

While the adjustments required for some inputs can be based on empirical data, for example cost increases due to inflation, a lack of transactions will often result in greater weight being given to heuristic inputs and the valuer's judgement.

It is inevitable that for weak markets with few transactions, valuations become less reliable. To help lenders understand the degree of uncertainty, and therefore risk, of a market value estimate, they should always ask the valuer to document their approach and reasoning for the valuation. However, inspected banks did not always ask their valuers to explain the sources of comparable evidence and what steps they had taken to validate it. While consistent rumours and hearsay evidence cannot be ignored because they can affect the decisions of actual buyers and sellers, evidence that has been verified should carry most weight. In a weak market there will inevitably be more rumour than fact, but in order to properly assess risk lenders need to understand the strength of the evidence on which the estimate of market value is based.

Another feature of weak markets is that sellers increasingly offer incentives, such as extending rent-free periods under a new lease or part exchange deals on purchases. To ensure that the underlying price in any comparable transaction can be relied on, banks should identify any such incentives and make appropriate adjustments.

Special assumptions should be clear and reasonable

Most common shortcomings:

- *accepting valuations based on unrealistic special assumptions*
- *failing to define special assumptions clearly*

In the world of valuation, a "special assumption" is one that assumes facts that differ from those that actually exist on the valuation date. It must be contrasted with a "plain assumption", which is simply something that it is reasonable to accept as true without specific investigation or validation. When valuing real estate, it is customary to agree that the valuer can make assumptions unless they find a reason to suspect a problem. For example, valuers do not have to verify legal titles or investigate inaccessible or hidden parts of a building because of cost and time considerations.

Valuations based on special assumptions can be a useful tool for lenders. For example, knowing what the value of a proposed development would have been on the reference date if it had been completed is important in understanding the viability of the scheme. Another example that can be useful from a risk

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assessment perspective is knowing what the effect on the value of an investment property would have been had the lease(s) been terminated and the property been vacant.

However, according to the on-site inspection results, there is often a lack of clarity in both the valuation reports provided to banks and in banks' understanding and use of values provided on special assumptions. According to the IVS, special assumptions must be reasonable, supported by evidence and relevant for the purpose for which the valuation is required. Lenders must take care that any special assumptions illustrate "what-if" scenarios and are clearly stated and reasonable in the context of the loan under consideration. They also need to ensure that they have received a market value "as existing" so that they can properly understand the impact of the special assumption. Because of their uncertainty, market values based on special assumptions are not appropriate for estimating expected credit losses.

Good and bad methodological practices

Most common shortcomings:

- *accepting valuations estimated using inappropriate methods or inappropriate inputs*
- *not ensuring that current market conditions were reflected in inputs to valuations of development projects*

The IVS group valuation methods into three main categories or "approaches": the comparable transactions approach, the income approach and the cost approach. For financial reporting, IFRS 13 follows a similar convention, permitting methods within the "market", "income" and "cost" approaches. The valuer has to select the most appropriate method or use a combination of them. The IVS are clear that the approaches are not mutually exclusive and that comparisons are essential to determining the appropriate inputs for all methods for estimating market value.

The on-site inspections revealed several cases where banks and valuers either adopted an inappropriate method or selected inappropriate inputs. Examples include:

- Some banks valued real estate held as collateral using the cost approach. This approach can be suitable for estimating the value of highly specialised real estate designed for a specific activity or process, and where there is no evidence of transfers of similar, unrelated property. However, while this method may be needed to produce a notional value required for financial reporting, the value of the property is intrinsically linked to the value of the activity supports.[4] The cost approach is therefore not suitable for loan security valuation and is accordingly prohibited by the AQR manual.

[4] An example would be a highly specialised manufacturing process which requires a building that is not only very expensive but also of little value for any other purpose.

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- While the IFRS do allow the cost approach to be used to determine the fair value of property held as investment, it is very rare that an investor would consider cost as being more relevant than returns. Some banks used this method because the properties had been vacant for a long period, so no relevant evidence of rent could be obtained and there were no sales of similar vacant property. The obvious lack of demand should have warranted a major depreciation for economic obsolescence, whereas banks only performed token adjustments for condition and age. Regardless of the method used, the focus must remain on the valuation objective, which is market value or fair value.
- Some valuers tended to continue to rely on the most recently published valuation parameters, even though these might not reflect current market developments. Lower transaction activity and the limited availability of comparative data do not exempt the valuer from adjusting the parameters to the current value conditions in the property market on the reference date.
- When valuing, some banks used multiple methods and averaged the results. The IVS encourage the use of multiple approaches, particularly when data are so scarce that a single method cannot produce a reliable value. However, they also say that the results should not be averaged. If different methods produce different results, the inputs used in one or more of the calculations may be inappropriate. The valuer should determine why the difference arises and reconcile this without averaging, and even reject methods if they are producing less credible results given the uncertainty around scarce data sources. The preferred method should always be the one that most market participants would use to determine what they would be prepared to pay or accept.
- Some banks valued properties that were occupied with little or no rent being paid as though they were vacant, disregarding the time and cost of obtaining possession. Conversely, properties that had been vacant for a long time were being valued on the assumption that they could be let in a relatively short period.
- In some cases, banks used asking prices as an input for the comparable transactions/market method, instead of prices based upon agreed transactions. The IVS indicate that if few recent transactions have occurred, the valuer may consider the prices of identical or similar assets that are listed or offered for sale, provided the data's relevance is clearly established and critically analysed. The weight placed on such evidence should consider the level of commitment by prospective buyers and how long the listing/offer has been on the market. An offer that represents a binding commitment to purchase or sell an asset at a given price should be given more weight than a quoted price without such a binding commitment. If the only available evidence is listed prices without supporting transactions, it indicates that buyers are not willing to pay these prices. In this case, and as a good practice approach, banks

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should either use another method to test any conclusion reached or use a haircut to estimate the price that probably would be agreed.

Residual method: caution is required

This method is used to estimate the value of CRE where development is either planned or in progress. In simple terms it involves estimating the value of the project as if it had been completed and then deducting all the costs a buyer of the property would incur in completing the project, as well as an allowance for the return they would expect for the time and risk involved. The amount left, the "residual", indicates the current value of the property.

The on-site inspections showed that the inputs used were frequently not being updated to reflect the significant change in market conditions from 2021 onwards, notably the steep rise in construction costs and interest rates, and the generally increased risks. The inputs to be used are the prices and rates that a buyer would have to pay on the reference date, even if the borrower may have secured a fixed rate contract and a fixed interest rate loan.

Further, the value of the existing property is often a relatively small proportion of the total cost. Banks should be mindful that, because of the large range of variable inputs needed, the residual value can be very sensitive to changes in those inputs.[5]

Wherever possible, valuations based on the residual method should be tested against another valuation method, although this too will often involve subjective adjustments when comparing development sites given that no two development projects are identical.

Lenders should exercise significant caution when relying on a market value based solely on a residual valuation and ensure their valuers provide a sensitivity analysis to illustrate the potential impact on the market value of changes in the cost and value inputs. They must also ensure that inputs reflect actual market conditions on the reference date. This information is important for setting limits, underwriting criteria and the build-up of reserves.

CRE lenders are still grappling with environmental risks

Most common shortcomings:

- *insufficient data collection on climate risks and energy efficiency for CRE assets*

5 For example, a proposed new office building project saw a 7.5% increase in total costs combined with a 7.5% reduction in the market value on completion. This scenario has been very plausible over the past few years, and it resulted in the estimated site value reducing by over 90%. By the same token, relatively small input changes in the other direction can enhance the residual figure.

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- *inadequate inclusion of capital expenditure needed to improve energy efficiency to an acceptable standard*

Climate change and environmental risks affect real estate in many ways. Buyers and developers of CRE are increasingly looking for buildings that have the best energy efficiency ratings and that can minimise carbon emissions, which is decreasing the value of less energy efficient real estate. Physical risks like flooding, wildfires and subsidence are similarly affecting demand and increasing the cost of development and insurance. Other regions around the world are concerned about the lack of ample fresh water supplies. Climate risks and the related costs also threaten cash flows from CRE, which in turn will have an impact on rental and capital values. The necessary capital expenditures will disproportionately affect the value of vulnerable assets, especially foreclosed ones. However, even though pricing is already clearly being affected, the inspections revealed that too many lenders are struggling to collect information about the environmental, social and governance factors affecting CRE assets. This also concerns obtaining basic information such as energy efficiency ratings. Only a few banks factor in the capital expenditures needed to improve energy efficiency to an acceptable standard in their affordability assessments.

Lenders should ensure that their valuers investigate and, wherever possible, collect data on environmental factors such as those set out in the IVS.[6] These include energy performance certificates, energy consumption, air and water pollution, biodiversity, climate change (current and future risks), clean water and sanitation, carbon and other gas emissions and resource scarcity.

Investigations should be more thorough, and valuers' work should be systematically reviewed

Some institutions were relying on valuations even though the valuers had not properly inspected the property or had only examined it externally without entering it. This led to material errors in the valuation samples reviewed during the on-site inspections. Examples include:

- the valuer not checking the extent of the property against the title plans or cadastral maps;
- the property being valued as vacant when there were long-term squatters in the property;
- significant interior (and even exterior) disrepair not being reported.

Banks must have effective frameworks in place for reviewing valuers' work so they can challenge the adequacy of valuation approaches and the calibration of parameter values. These reviews must also include foreclosed assets and other investment properties, given that their values have a direct impact

[6] IVS 2025 104 - Appendix A10.03.

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on a bank's balance sheet. The checks need to be thorough and documented, and business lines must refrain from interacting with valuers.

Reflecting market trends in a timely manner is a cornerstone of valuation

Most common shortcoming:

- *insufficient allowance made for risks to collateral value due to time lag and changing occupier requirements, especially for office and retail buildings*

As already mentioned, some of the campaign findings concerned valuation inputs from 2022 and 2023 that did not sufficiently reflect current market conditions. In addition, there are also other longer-term market trends which will likely affect values and which lenders need to consider in their risk assessments.

- Since the market downturn began in 2022, the risk premium has fallen, i.e. the margin between yields on "risk-free" government bonds and yields from CRE investments has shrunk. While both have increased, the yields from CRE have not increased to the same extent as those on government bonds. This compression of the risk premium is not signalling that investors regard CRE investment as being less risky than government debt. Rather, it reflects the current relative illiquidity of the CRE market. While risk-free bond yields may have peaked, CRE yields are more likely to increase in the short term.
- The office and retail markets in particular are undergoing structural changes in the pattern of demand, with many older properties being either located away from prime areas or incapable of undergoing the modifications that occupiers now demand, especially concerning energy efficiency and physical climate risks. Consequently, differences between prime rents and yields and the secondary sector are increasing and this trend will likely continue.

All other things being equal, this increase in risk premia will negatively affect appraised values, with an especially pronounced impact on assets that have been overvalued in the current downturn. A number of valuers tend to assume that leases will be renewed under the same terms and without significant improvement expenditures being required by tenants. When using a discounted cash flow model, they sometimes establish terminal values based on the headline contracted rents, irrespective of the existence of significant rent-free periods being granted to support those headline rents.

Lenders should ensure that these anticipated and well-documented trends and practices, which could adversely affect the current value over the life of the loan, are properly reflected in the loan terms offered and that their CRE loan portfolios are adequately provisioned. It is premature to assume that

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market values have reached their lowest point in sectors at risk, given the time lag and, in some cases, the positive biases we have observed in valuations.

Valuing large real estate portfolios: shortcomings in the models used

Most common shortcomings:

- *use of automated valuation models without sufficient oversight or consideration of abnormalities in portfolio*
- *funding buyers of securitised loans without adequate investigation or understanding of CRE assets in portfolio*

Some borrowers finance large real estate portfolios via traditional lending or in the context of securitisation. The repayment of the loans primarily relies on selling the properties within these portfolios or on the overall value of the portfolios, regardless of whether they are given to lenders as collateral. Borrowers tend to opt for statistical models or automated valuation models (AVMs) to value such portfolios, mainly because of cost and time considerations.

These models can have significant shortcomings, especially when dealing with less liquid assets or in the event of significant market decline. They are based on historical data and are therefore subject to a time lag when market conditions change. They also fail to determine important features of the property, such as the layout and overall condition (including any necessary renovations), and they do not consider specific conditions of very local markets, especially in areas undergoing transformation.

These significant limitations were not always recognised by banks, some of which overly relied on the models. The European Banking Authority's guidelines on loan origination[7] allow "advanced statistical models" to be used as supporting tools, providing these are assessed, reviewed and approved by an internal or external valuer, who should understand all model inputs and assumptions. If the model's confidence measure is low or other property-specific information causes uncertainty about the result, banks should consider methods other than desktop valuation. The guidelines set criteria for AVMs, including that they must be sufficiently representative and granular in terms of property type and location, subject to regular back testing against actual prices and based on a sufficiently large data sample.

As good practice, lenders should ensure that a representative sample of properties are inspected on a rolling basis at each revaluation date. If the sample investigated exhibits problems, banks can apply

[7] Section 7.1.1 of European Banking Authority (2020), *Final Report – Guidelines on Loan Origination and Monitoring*, 29 May.

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an appropriate percentage reduction across the portfolio. However, the inspectors found cases where it was evident that the AVM results could not be trusted as a reliable indicator, especially for problem or illiquid assets, without further investigations. It is not appropriate to assume that there are no problems with properties if they have not been inspected.

The valuation of property companies is a critical element of lenders' decision-making

Property companies often serve as sponsors for asset-based lending entities. Lenders can also offer them unsecured financing. It appears that banks lack comprehensive information on the property valuations of these companies, which are crucial for assessing their net worth. This is particularly harmful because some of these companies might be tempted to rely on unrealistic or outdated data or assumptions to secure their funding, especially in the current context. Lenders to these companies should ensure that they obtain sufficient information on the assets held by these companies, including the most recent valuations, and critically review how these were undertaken, both at loan origination and for monitoring purposes.

Information-sharing between supervisors, auditors and standard-setters enables appropriate CRE valuation

At this moment in time, understanding real estate valuations is more crucial than ever and an important factor for evaluating banks' risk management frameworks for CRE holdings. Supervisors across the globe are facing similar issues in this area, and ECB Banking Supervision actively shares the experience gained over several years of inspections. The CRE on-site inspections campaign team will further engage a dialogue with external auditors and CRE standard-setting bodies.

The authors would like to thank the following contributors and reviewers: Dirk Fischer-Appelt, Christian Robinet, Henry Robinson, Juan Marcos de Orueta, Gianluca Urti, Muriel Tiesset, Pietro Giammario, Alessandro Santoni, Janine Richter, Anne Fitterer, Riccardo Rocco, Raphaël Herfray, James Allwood, Mário Roldão, Kathrin Zander, Matthew Hopkins.

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