

EBA/Op/2015/17

5 October 2015

Opinion of the European Banking Authority on Mortgage Lending Value (MLV)

Introduction and legal basis

According to Article 124(1) of Regulation (EU) No 575/2013 (CRR), the part of an exposure treated as fully secured by immovable property can be determined based on mortgage lending value (MLV) in those Member States that have laid down rigorous criteria for the assessment of MLV. The EBA has the mandate to develop the draft Regulatory Technical Standards (RTS) to specify the rigorous criteria for the assessment of MLV, as specified in Article 124(4)(a) of Regulation (EU) No 575/2013 (CRR). MLV is a concept defined in the CRR (Article 4(74)), as follows:

‘the value of immovable property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property’

The mandate for the RTS on MLV is given in the context of the Standardised Approach, where capital requirements for exposures secured by mortgages on immovable property are specified. In addition to the use of MLV in the Standardised Approach (Article 124, 125 and 126 CRR), the concept of MLV is referred to in the CRR in the context of the credit risk mitigation framework (Article 229 CRR) and in the large exposures framework (Article 402 CRR). Furthermore, MLV is linked with capital requirements for exposures in the form of covered bonds. Article 129 CRR sets out a number of requirements to qualify for a preferential risk weight on covered bonds, which includes in Article 129(3) CRR an indirect reference to the concept of MLV given its reliance on the credit risk mitigation framework (Article 229(1) CRR).

The EBA understands that these RTS setting out the rigorous criteria for the assessment of the MLV to the valuation of immovable property collateral will apply for prudential purposes in the credit risk area (Article 124, 125 and 126 CRR), the credit risk mitigation framework (Article 229(1) CRR) and in the large exposure regime (Articles 402(1) and 402(2) CRR). This interpretation is based on the fact that MLV is defined as a single concept in the CRR. This mandate will therefore lead to a harmonisation of the rigorous criteria for the assessment of the concept of MLV, which is key for the prudent assessment of risks stemming from exposures secured by immovable property, and as such fully supported by the EBA.

The EBA has however also concluded that the CRR implies that the valuation of the immovable property collateralising covered bonds would also need to be based on the RTS on MLV in order to meet the eligibility criteria of preferential covered bond risk weight, due to the wording in Article 129(3) CRR, which refers to the requirements on MLV in the credit risk mitigation framework in Article 229(1) CRR. Given that national legislation cannot specify criteria which are additional to or different from those in the CRR, this would imply that institutions need to meet the rigorous criteria specified in the RTS on MLV in order to fulfil the requirements in Article 129 and, indirectly, in Article 229 CRR¹. The EBA considers that the applicability of these RTS for the valuation of covered bond collateral in order to meet the eligibility criteria of the preferential risk weight is problematic given its impact on European covered bond markets, somewhat indirectly, and consequently the EBA advises in this Opinion that the RTS on MLV should not apply for the valuation of immovable property collateralising covered bonds for the purpose of ensuring the eligibility of the preferential risk weight for these covered bonds (Article 129(3) CRR) nor to covered bonds in general.

By issuing this Opinion, the EBA advises the Commission, based on the considerations outlined below, that the scope of application of the RTS on MLV should be limited to the Standardised Approach, Credit Risk Mitigation framework and Large Exposures. Should the Commission clarify that the RTS on MLV also applies to the valuation of immovable property collateralising covered bonds for the purpose of ensuring the eligibility of the preferential risk weight for these covered bonds (Article 129(3) CRR), the EBA advises the Commission to initiate appropriate legislative steps, i.e. to amend the CRR, to limit the scope of these draft RTS on MLV.

This Opinion is primarily motivated by the fact that there is a substantial risk of introducing a disproportionate cost on both competent authorities and institutions merely by changing this aspect (i.e. the valuation methodology for assessing MLV) in the covered bond legislation. While the EBA sees merits in seeking a more harmonised covered bond market, including harmonisation of the valuation of assets in the pool of underlying collateral, the EBA believes that it would be more appropriate from both a legal and financial stability perspective to take a more comprehensive approach to the valuation methodology used for covered bonds.

In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors², the Board of Supervisors has adopted this opinion.

¹ Note that a change in national covered bond legislation would not be necessary *de jure* when the RTS on MLV are adopted: it is only required for immovable property collateralising covered bonds to meet the valuation rules set out in Article 229(1) CRR for the purpose of meeting the eligibility criteria of the preferential covered bond risk weight. On the basis of the above understanding, immovable property collateralising covered bonds can still be valued according to national valuation rules, but these covered bonds are not eligible for the preferential covered bond risk weight. However, the importance of this preferential risk weight in the covered bond market is likely to mean that a change in covered bond legislation is *de facto* necessary. Covered bonds issued before 31 December 2007 are in addition not subject to the requirements set out in Article 129(1)-(3) in order to qualify for the preferential covered bond risk weight.

² Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 11 December 2013 (Decision EBA DC 001 (Rev3)).

Background

The CRR allows in each reference (Article 124(1), 125(2)(d), 125(3)(a), 126(2)(d), 126(3), 402(1), 402(2) and 229(1) CRR) both the use of market value (MV) and MLV to determine the value of immovable property. MV is defined in Article 4(76) CRR as *‘the estimated amount for which the property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion’*. The purpose of MLV, as defined in Article 4(74) CRR, is to provide a long-term, sustainable value as a stable basis for judging the suitability of a property as a security for a mortgage which will continue through potential market fluctuations. The main difference between the MLV and the MV is that the MLV is intended to be an estimate of the value of the property for a long period of time, whereas the MV is an assessment at the valuation date.

In the context of setting capital requirements for covered bonds, Article 129 CRR, requires in the third paragraph that “Institutions shall for immovable property collateralising covered bonds meet the requirements set out in Article 208 and the valuation rules set out in Article 229(1).” Article 229(1) CRR specifies that “For immovable property collateral, the collateral shall be valued by an independent valuer at or at less than the market value.” ... “In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions the property may instead be valued by an independent valuer at or at less than the mortgage lending value.”

Given that MLV is a concept defined in the CRR and given that the exact same wording on MLV is used in Article 229(1) CRR, a legal reading of the CRR would appear to imply that the draft RTS setting out the rigorous criteria for the assessment of the MLV would have to be applied for the assessment of the value of immovable property collateralising covered bonds in order to meet the criteria for the preferential treatment of capital requirements in Article 129(1) CRR. This interpretation is based on the fact that MLV is a concept defined in the CRR (Article 4(74) CRR), and this understanding is reinforced by references in Article 125 and 126 to the same Article 229(1) to which also Article 129 CRR refers.

EBA considerations on the impact of harmonised criteria for the assessment of MLV for covered bonds

The legal reading regarding the applicability of the RTS on MLV to the valuation of covered bonds for the purpose of meeting the CRR requirements raises several concerns for the EBA. While the CRR does not require a change to covered bond frameworks directly (as explained in footnote 1), it implies that institutions will not be allowed to apply the preferential risk-weighting in Article 129 CRR, unless the collateral is valued at or at less than the market value³ or at or at less than mortgage lending value in those Member States that have laid down rigorous criteria for the

³ Note that whereas MV is defined in the CRR (Article 4(76) CRR), no harmonised criteria for the assessment of MV apply.

assessment of the mortgage lending value in statutory or regulatory provisions, and unless all other relevant conditions are met. The EBA presents below the advantages and disadvantages of applying the RTS on MLV for covered bond purposes, but opines that the disadvantages outweigh the benefits arising from the scope of harmonisation of the MLV concept, at least in the short-term.

First, the application of the RTS on MLV to covered bonds would require legislative changes in those EU member states that apply the MLV in their covered bonds legislation in order to ensure that the covered bonds issued under their jurisdiction qualify for the preferential risk weights foreseen by the CRR. In the absence of such changes, all currently outstanding covered bonds issued under frameworks relying on MLV, as well as bonds issued going forward, would not be considered CRR-compliant and would be subject to higher capital requirements. In addition, non-compliance with Article 129 CRR would have broader disruption implications, as such compliance appears to be referenced more broadly within markets, for instance in investment guidelines for some covered bond investors. Only a substantial phase-in would possibly mitigate such risk.

A second argument is that it would also be more appropriate from both a legal and financial stability perspective not to change individual aspects in national covered bond frameworks, but to implement such changes in an integrated manner. In this context, the EBA considers it more appropriate that the possibility to change the criteria for the assessment of MLV in covered bond markets be considered as part of a more comprehensive review of EU covered bond frameworks, as foreseen in the Green Paper on Building a Capital Markets Union⁴ (published in February 2015). According to this paper, the Commission will consult in 2015 on policy options to achieve greater integration in covered bond markets. Potential convergence in the practices of valuation of immovable property collateral would have to be considered in conjunction with other aspects of the covered bond transaction which interact with valuation, e.g. the frequency of the collateral re-valuation as well as the principle of coverage adopted by the covered bond framework. Changes to isolated aspects of the transaction may therefore risk becoming counterproductive.

The harmonisation of rigorous criteria for the assessment of MLV across national covered bond markets in the EU (as well as in the prudential framework, i.e. Standardised Approach, Credit Risk Mitigation framework and Large Exposures) also has positive effects which the EBA has considered carefully. The benefits would stem from (i) increased transparency and comparability for market participants about the value of the underlying collateral, no matter the jurisdiction where such collateral is located, (ii) lower operational costs associated with maintaining and applying two different valuation standards (prudential framework and covered bond framework) and (iii) an enhanced integration of the single market for covered bonds, if the criteria were appropriate.

In light of the above, the EBA assesses that risks of disruption in national covered bond markets and implementation costs that would be associated with the application of the RTS on MLV for assessing capital requirements on covered bonds, at this stage, outweigh the advantages. As such,

⁴ http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf

the EBA issues this Opinion primarily to advise the Commission that the scope of application of the RTS on MLV should be limited to the Standardised Approach, Credit Risk Mitigation framework and Large Exposures. Should the Commission clarify that the RTS on MLV also applies to the valuation of immovable property collateralising covered bonds for the purpose of ensuring the eligibility of the preferential risk weight for these covered bonds (Article 129(3) CRR), the EBA advises the Commission to amend the CRR to limit the scope of these draft RTS on MLV. In addition, the EBA suggests that any aspect of harmonising the valuation practices in covered bond markets could best be considered as part of a more comprehensive review of EU covered bond frameworks.

EBA considerations on procedures on the application of the MLV

The EBA also notes that the CRR does not provide sufficient clarity as regards the procedures to be applied for the application of MLV in Member States. The EBA considers that further clarification is necessary on when MV and when MLV may or should be applied for the valuation of immovable property collateral, be it to qualify for the preferential treatment of covered bonds or for prudential purposes, and whether the institution or the member state has the right to decide on the valuation of properties by MV or MLV.

The first issue is how it should be understood that ‘Member States have laid down rigorous criteria for the assessment of the mortgage lending value’. As the situation stands today, some Member States have issued national legislation on MLV, which given the normal principle of maximum harmonisation of regulations, will not be allowed to co-exist along-side the adopted RTS on MLV. It is unclear whether the existence of national legislation on MLV prior to the adoption of the RTS on MLV is sufficient to fulfil the requirement or whether Member States will need to issue an indication that they will apply the MLV principle, as laid out in the RTS on MLV. In this regard it is equally unclear, which procedures Member States must follow, should they choose to apply the MLV when the Member state did not have such regulation in the past.

Furthermore, it is unclear from the CRR whether immovable property collateral can be valued by MV after the RTS on MLV will be adopted in those MS which currently have a national regulation on MLV implemented. The wordings in Article 124(1) and Article 229(1) CRR are very similar⁵, but they are nevertheless different since Article 229(1) CRR seems to allow a choice (i.e. optionality for MLV), whereas it is unclear whether Article 124(1) CRR also allows such choice. Furthermore, it is not clear what would happen in those Member States which have laid down rigorous criteria for the assessment of MLV in their national covered bond legislation, but not for prudential purposes.

⁵ The second subparagraph of Article 124(1) CRR refers to “the pledged amount of the MV or (the MLV of the property) in those MS that have laid down rigorous criteria for the assessment of the MLV in statutory or regulatory provisions”, whereas Article 229(1) CRR refers to “the collateral shall be valued at or at less than the market value. ... In those MS that have laid down rigorous criteria for the assessment of the MLV in statutory or regulatory provisions the property may instead be valued ... at or at less than MLV”.

The EBA considers it necessary, that such procedures are established, just as it considers it a prerequisite that Member States must have the flexibility to apply the concept of MLV or MV in their jurisdiction, irrespective of whether such national MLV regulation was already implemented before the adoption of the RTS on MLV.

The second issue is related, and is whether this choice (or optionality) between MV or MLV described above is for the institutions or the Member States. The wording of the CRR does not make clear whether the choice of applying the MLV or MV is a matter for institutions or Member States in those jurisdictions that apply the MLV. In Article 229(1) CRR, the institution is explicitly referred to in relation to the requirements applicable to the valuer, whereas this is not the case in Article 124(1) CRR (as well as Article 125(2)(d) CRR and Article 126(2)(d) CRR).

Based on the historical implementation, the EBA is of the view that the Member States should specify the use of the MLV principle. In particular, the Member States should be allowed to specify where the MLV valuation methods are to be used in the prudential framework, i.e. for instance only for covered bonds. Allowing the choice of valuation to the institutions, may also lead to valuation practices being used in an inconsistent way across institutions.

The EBA considers it necessary that these issues are clarified before the draft RTS on the rigorous criteria on MLV can be submitted to the Commission. Operational consequences of a change of the valuation of immovable property collateral are high as such valuation plays a central role in the calculation of capital requirements and in covered bond markets.

Next steps

The EBA is consequently of the opinion, that the Commission should initiate legislative steps to clarify the scope of the RTS empowerment to exclude any implications on covered bonds. The EBA opines that it would be preferred, both from a legal and from a prudential perspective, that the rigorous criteria for the assessment of the MLV specified in the RTS on MLV would only apply for prudential purposes in the credit risk area (Article 124, 125 and 126 CRR), the credit risk mitigation framework (Article 229(1) CRR) and in the large exposure regime (Articles 402(1) and 402(2) CRR), but not for the purpose of meeting the eligibility criteria for the covered bond preferential risk weight (Article 129(3) CRR). In addition, EBA notes that any aspect of harmonising the valuation practices in covered bond markets could best be considered as part of a more comprehensive review of EU covered bond frameworks, just as steps could be taken in this regard to clarify the scope of application of the RTS to cover only the prudential scope.

The EBA also notes that clarity should be brought on the procedural aspects related to the application of MLV in those Member States that has decided to apply the MLV principles for prudential purposes instead of the MV, in particular regarding the procedural aspects which need to be followed to indicate that immovable property should be valued by either MV or MLV. In this regard, the EBA opines that Member States should specify the use of the MLV principle, rather than the institutions.

Until such clarification is made, the EBA notes that it is not possible to progress further with its work on the mandate in Article 124 (4) (a) CRR.

This opinion will be published on the EBA's website.

Done at London, 2 October 2015

(signed)

Andrea Enria

Chairperson

For the Board of Supervisors