Valuation, valuation, valuation

Surveyors have an important role to play if the housing market is to function more effectively, especially if securitisation is revived, says **Oonagh McDonald**

The years since the financial crisis have demonstrated the importance of property valuation for secured lending, and itseven greater importance for securitisation. Disaster follows if the underlying assets have not been properly valued.

While the UK was still reeling from the financial crisis, lenders concluded that surveyors had, in particular, over-valued residential property and they sought redress for the losses that they had suffered. The big losses were a result of the large number of repossessions. Between 2009 and 2012, approximately 250,000 homes were repossessed. Almost 90 per cent were sold at a loss, that is, at a price below the balance of the remaining mortgage.

Loss severity, defined as the sale price achieved versus the current balance of the loan at the time of sale, reached 31.4 per cent in 2012, up from 27.6 per cent in 2010. Apart from heady valuations, that was because of high loan-to-values (more than 100 per cent) in 2007 and 2008, leading to a greater loss. In addition, lenders often sell at a discount for a quick sale.

To make up their losses, lenders turned to the professional indemnity insurance held by surveyors. Thousands of "confetti" letters were sent out in 2009 from the banks' lenders, which put many surveyors on notice that the lenders believed that they had claims against such firms, relating to the over-valuations of a large number of residential properties. Most of the claims have still not been followed up but, as they are claims made, the professional indemnity insurers have increased the premiums paid by firms undertaking residential valuations.

As a result, many small firms have not been able to undertake secured lending valuations and others have decided that carrying out valuations for secured lending is too risky. The shortage has resulted in surveyors being instructed to undertake too many valuations in one day but also out of their area or their specific expertise.

It is unlikely that such a deluge of "confetti" letters will be sent out in the future, given the implementation of Lord Justice Jackson's Review of Civil Litigation and the subsequent changes in the law contained in the Legal Aid, Sentencing and Punishment of Offenders Act, 2012, which came into force in April 2013. It effectively ended "after the event" insurance.

To deal with the current situation, one of my recommendations was that lenders should instruct their solicitors to withdraw many, if not the majority, of claims on which no further action has been taken. This should have the effect of reducing the costs of professional indemnity insurance. This should enable the market to function more effectively, but also help to ensure that there are sufficient surveyors, which is essential not only for the residential market but also for securitisation.

> With cheap funding, banks do not need to attract retail deposits

Securitisation in the UK has not yet revived, largely because of the extension of the Funding for Lending scheme to January 2015. Since banks can obtain cheap funding from the Bank of England, they do not need to consider securitisation; indeed, they do not need to attract retail deposits either, so some banks have lowered the interest rates paid on deposits still further, even though the low base rate had already made them unacceptable to savers.

Despite the lack of final rules at present, some are hopeful that securitisation will be rehabilitated. Basel 3 still seems to penalise high-quality securitisation. Hopes of a revival seem to depend on the European Commission's March 27 paper, "Long-term Financing of the European Economy", which recognises securitisation as one of the key means of ensuring that capital flows into the real economy.

It includes recommendations for lighter capital requirements for institutional investors to hold paper under Solvency 2, which should encourage the insurance industry to buy asset-backed securities, with better disclosure, transparency regarding the quality of the underlying assets, and greater product standardisation. Transparency around the quality and value of the underlying assets was absent and often falsified in the securitisation of subprime mortgages in the US, for which everyone paid the price. Surveyors take the centre stage for this part of the process.

The Mortgage Credit Directive requires lenders "to monitor the value of the property on a frequent basis and at a minimum once every year for commercial property and once every three years for residential real estate". Lenders should carry out "more frequent monitoring where the market is subject to significant changes in conditions". The lender must also ensure that the valuer should be "independent from the credit decision process". The requirement for "independence" does need to be spelt out more clearly with due attention to conflicts of interest, where the valuer may be employed by the bank or work for a company in the same group as the lender.

With regard to securitisation in highly volatile housing markets, monitoring changes in the market may well not be sufficient. House price indices may not indicate in sufficient detail how much the changes have affected market values in a specific area. There should be a further requirement for a valuation immediately prior to loans being securitised. Lenders may leave the loan on their books for months or years before deciding to securitise the loans. A new valuation would help to ensure that securitisation would better reflect the value of the underlying assets.

The German question

The situation in Germany is unusual: indeed, Germany was described as an "outlier" in terms of owner-occupancy rates at 44 per cent in an Occasional Paper published by the European Central Bank in 2009. The results of the 2011 census in Germany, published by the German Federal Statistical Office in 2013, showed that 58.1 per cent owned their own homes but that only 42.4 per cent live in their own homes.

This unusual approach to home ownership has to be seen in the context of German property taxation and rents. Deducting the financing costs and depreciation of owner-occupied housing from income tax was abolished in 1987. The financing costs of rented property are still tax deductible. Taxes and other charges on house purchases seem to be higher than those in other countries.

Rents are negotiated between landlords and tenants with unlimited forms of contract being the most usual. Limited contracts are possible, but only where the landlord has a good reason, such as requiring the house for himself or his family. The contract may allow for indexation of the rent but, where it does not, the landlord may require the tenant to accept an increase to the predominate rent level in the area, and, as a general rule, any increase in the rent is limited to 20 per cent over three years, with no increase allowed in the first year. Further, the landlord must provide reasons for rent increases.

Germany's rental laws have stopped a property bubble forming, making the country attractive to investors, including foreign ones. While rent rises are stable and prices less volatile than in other markets, residential property seems to be a good, safe investment. However, rents have increased in the main cities much more than they have in the rest of the country. In Berlin, rents have risen by 35 per cent since 2007, as they have also in Munich and Hamburg. Landlords have taken the opportunity presented by gaps in contracts to raise the rents as well as increasing them by the maximum allowed under the contracts.

There are signs of change. Property companies record brisk residential sales and rising prices in the main cities where the Bundesbank claims that house prices are over-valued by as much as 25 per cent. That claim depends on the "mortgage lending valuation" used to back mortgage loans, which run for 25 to more than 30 years, assuming a redemption of 1-2 per cent per annum.

The value must be valid for this whole period and is not, therefore, the market value, which is only valid for a point in time. The mortgage lending valuation depends on the net rental income, which the property produces over time, taking into account the long-term market trends, excluding the operational costs of letting, including tenant risk. The capitalisation rate is then applied, based on long-term market trends, the property's sustainable income-producing capacity and its future marketability. Extensive data covering rents as well as land and the ownership of housing make it possible to estimate the mortgage lending value. Properties with a stable valuation are eligible as assets for covered bonds, but only up to 60 per cent.

The Mortgage Credit Directive recognises both market value and mortgage market value as major risk management tools for lenders. Such value is also collateral that translates into preferential risk weights for capital requirement purposes. The Capital Requirements Regulation recognises both approaches to the valuation of residential property for the purposes of the required capital. For Germany, the essential role of the mortgage lending value is to secure the Pfandbriefe, which is a long-standing and successful market. Extensive data covering rents as well as other aspects of land and ownership of housing made it possible to assess the market value.

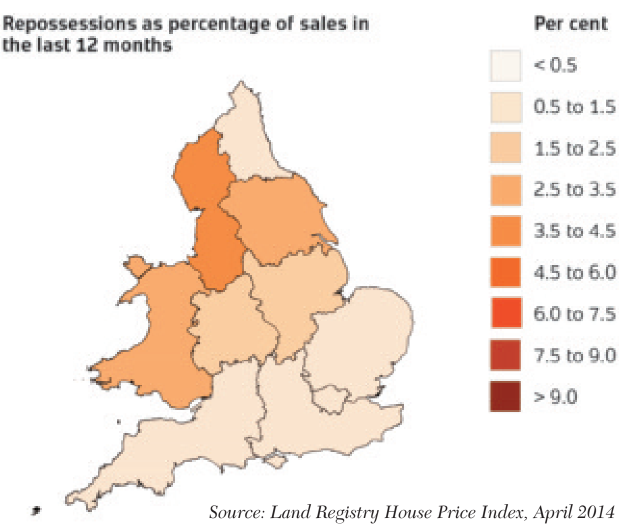
The mortgage lending value rests on the stability of the German housing market over recent years, and the ability to assess the value in these terms depends on the degree to which rents are regulated. However, if the housing market is beginning to change, then it may not be possible to lean on stable forecasts of rents. If the market changes, as it will, if the foreign investors continue to pile in and if low interest rates encourage more people to buy and occupy, rather than use residential property as a means of investing for the future, then it may not be possible to sustain the methodology of the mortgage lending valuation.

Oonagh McDonald CBE is author of an independent reports commissioned by the Royal Institute of Chartered Surveyors, January 2014: Balancing Risk and Reward: Recommendations for a Sustainable Valuation Profession in the UK

Regional repossession sales

Region	January 2014	January 2013	Difference
East	66	101	-35%
East Midlands	93	127	-27%
London	117	194	-40%
North East	25	43	-42%
North West	237	297	-20%
South East	108	170	-36%
South West	57	88	-35%
Wales	78	115	-32%
West Midlands	61	93	-34%
Yorkshire & The Humber	137	192	-29%
Total	979	1,420	-31%

Repossessions as percentage of sales in the last 12 months



Source: Land Registry House Price Index, April 2014