

Comprehensive Assessment Circular No. 3

Pragmatic approach to collateral and real estate valuation

15 March 2016

This circular provides clarifications around work-block 5 “Collateral and real estate valuation” of the Manual. The timeline and specific steps to valuations are already outlined in Circular No. 1. This work-block shall be performed in conjunction with work-block 4 “Credit file review” (CFR). The aim is to ensure that all immovable properties used as a security for the reviewed exposures have been appropriately valued.

In addition, a separate guidance on the valuation of physical assets held in the banking book through investment or foreclosure will follow shortly.

Overview

The valuations should be performed by the AQR Providers or by their subcontractors – licensed appraisers.

Applying the principles of: i) the International Valuation Standards 2013 (IVS); ii) the European Valuation Standards 2012 (EVS, Blue Book); iii) the guidelines of the Royal Institute of Chartered Surveyors (RICS); and if more conservative - iv) the locally-established best practices, to specific situations, is within the discretion of the Appraiser and will require the exercise of expert judgment. The judgment must be applied objectively and should not be used to overstate or understate the valuation result. The quality assurance (QA) of the assumptions supporting a value conclusion remains an obligation of the AQR Provider.

Restrictions

- All physical assets should be valued on the basis of market value, as defined in the Manual;
- Depreciation replacement cost (DRC) method shall not be accepted;
- Valuations dated and/or completed after 31.12.2015 have to be reviewed and confirmed by the Appraiser and should be properly documented in writing;
- Whenever the collateral is i) a pledge on future receivables under current accounts¹; ii) a promissory note; or iii) a personal guarantee, AQR Providers should consider this to be of zero value for the purposes of impairment calculations;
- Whenever the collateral is a pledge on an entire commercial enterprise, the Appraiser should perform a business valuation (liquidation premise) and should take into account the aggregate value of the outstanding loans secured with the assets of the enterprise;
- Given the significant uncertainty of expected future cash flows related to development projects, no hope value may be ascribed to land with planning or ongoing developments². Such properties should

¹ Amounts available in properly structured debt service reserve accounts are considered at face value.

² Reference to Manual “5.6.1.3 Valuation reflecting hope value”.

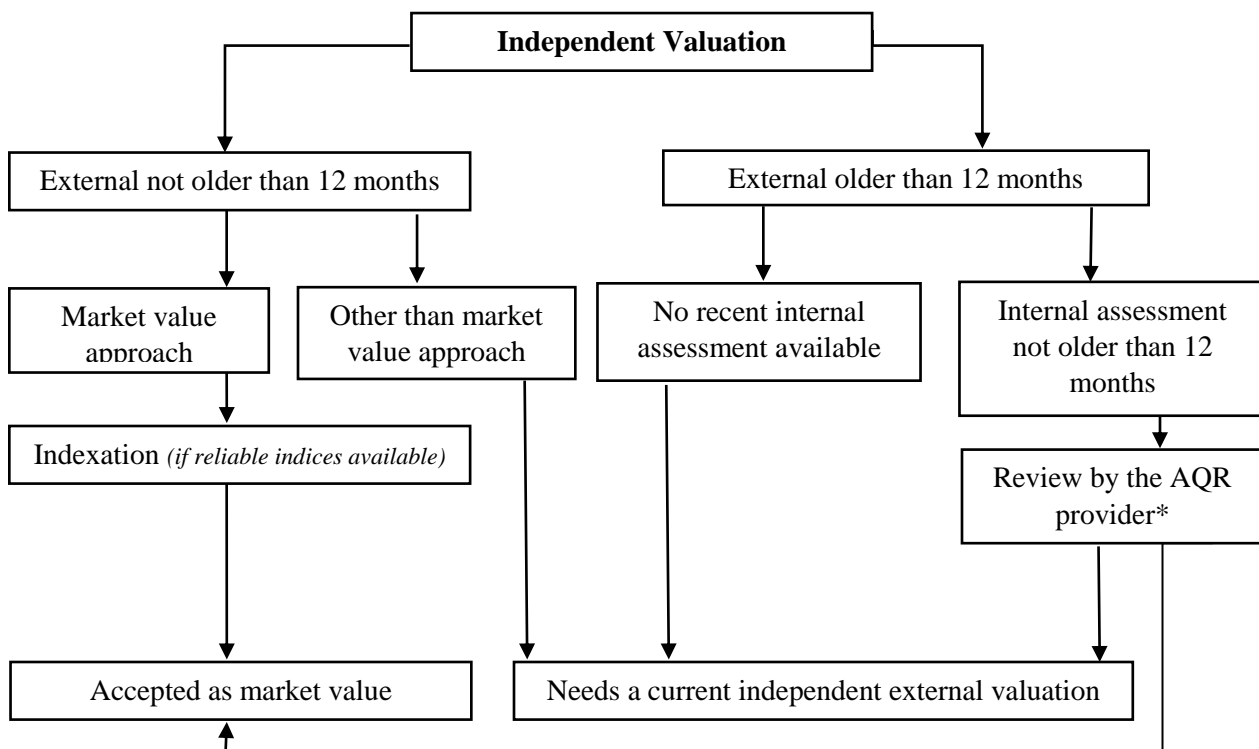
be valued on a market approach basis (e.g. discounted cash flows from actual operations or comparable transactions).

Submission of BNB T5

- One BNB T5 template should be submitted per in-scope portfolio segment;
- Collateral items securing all targeted, priority and sampled exposures should be reviewed by applying the decision tree below;
- For sampled Corporate and SME AQR segments, valuation reviews and/or collateral revaluations are required if there is evidence for impairment or if future losses are more likely;
- The methodology for appraisal of property laid out in the Manual intends for valuations to be performed on at least per building level, i.e. multiple properties in the same building may be valued in aggregate where appropriate;
- All valuations should be entered into the template in thousand BGN.

Decision tree

The following diagram gives a guideline when an independent external valuation should be performed:



* The AQR provider should consider all available information on file whether by external or internal certified parties to support a value conclusion.

It is emphasised here that if a bank is unable to provide the information required by the Appraiser to support a value conclusion, a value of zero will be attributed to the collateral item.

If a significant number of valuations (desk based or drive by) performed by the Appraiser show deviations by more than 10% than the bank’s valuation reports on file, then the in-scope bank may be required to have an independent, external party reappraise the entire foreclosed real estate portfolio.

Following the completion of reappraisal of collateral securing exposures in the sample, AQR Providers should calculate the average difference from the latest available appraisal report on file. If a significant number of valuations (desk based or drive by) performed by the Appraiser show deviations by more than 10% than the bank’s valuation reports on file, for any type of collateral as per Table I below, the BNB will

instruct the AQR Provider to make a further adjustment with the respective percentage difference to be applied to all collateral of the same type outside the reviewed sample, i.e. in the extrapolation process.

Benchmarks

The review of the AQR Provider team is relevant to assets valued under the gone concern approach – Manual reference “4.6.1 Gone concern approach” and “5.6 Real Estate valuation approach.

The following assumptions represent guidance to AQR Providers when performing a sanity check during their quality assurance review of the reappraised real estate.”

Calculation of recoverable amount of collateral is outlined in Section 4.6.1 “Gone concern approach” of the Manual. The starting point to application of costs related to sale of collateral is the collateral market value as per the reappraisal or accepted bank appraisal.

Liquidation proceeds from the collateral should include market value of collateral, adjusted for expected falls (but not rises) in market value of collateral in the time between observation and sale. For the purpose of the AQR exercise in Bulgaria, estimation of potential expected falls should be based on analysis performed by the AQR Provider³.

The estimation of the costs associated with the monetization of the collateral should be based on the suggested i) aggregate costs for liquidation applied at closing (as per II below) and ii) ongoing costs over the expected time to sell (as per III below). The costs will be discounted by the effective interest rate of the exposure considering the suggested selling times for collateral types according to Table I.

For the avoidance of doubt, the selling time in Table I incorporates i) the length of legal proceedings to repossess the asset or dispose of through insolvency procedure, and ii) market time to sell.

The selling time for residential properties factors in an average length of legal proceedings (as per i. above) of 6 months for agricultural land, 12 months for residential properties (houses and apartments) and for all other collateral types – 36 months. The data outlined in Table I should be used to substitute for variable *t* in the formula on p. 126 of the Manual⁴.

Selling time starts as of the moment of sending a formal letter to the borrower requesting repayment of the full face amount of the loan commitment.

I. Selling time / Type of collateral	Months		
	Prime location ⁵	Secondary location ⁶	Tertiary location ⁷

³ This paragraph amends Section 4.6.1 “Gone concern approach”, Paragraph 6, last sentence “*To take into account expected falls (...)*”.

⁴ When the effective interest rate (EIR) is measured on annual basis, the unit of measure should be converted from months to years.

⁵ For example, these would be the most expensive per m² and the most favorable locations. For a shop/office, this might be a location in a high street or the main part of a shopping center.

Residential house	24	30	36
Residential apartment	16	18	24
Industrial property	60	66	78
Offices	42	48	60
Retail property	42	48	60
Hotel	52	60	66
Agricultural land	12	12	12
Other land (no planning permission)	54	60	72
Other land (with planning permission)	44	48	54

II. Costs of liquidating the collateral (variable cost of the procedure at closing):

1. 9% if value of individual property is less than 500 ths BGN
2. 5% if value of individual property is more than 500 ths BGN

III. Servicing cost - ongoing (per quarter): 0.25%

Shorter selling periods could be applied only in cases where there is unequivocal evidence, provided by the bank, that the monetization of the collateral is in an advanced stage as at the AQR reference date (31-Dec-2015), subject to the implied market time to sell above. Events which happened after the reference date, related to the monetization of collateral, may be taken into account, only if confirmed by the AQR Provider.

⁶ Regular locations, neither very preferable nor undesirable. For shops/offices this might be one within walking distance of the high street or situated near business parks and clusters.

⁷ The least favorable locations and typically also the least expensive per m². For shops/offices this might be located in the outskirts of towns or ones with lack of convenient transport utilities.