

STATEMENT OF PRINCIPLES ON THE MORTGAGE VALUE OF REALTY

I. The philosophy of the mortgage value in accordance with § 12 Private Mortgage Banks Law (HBG)

The way in which the value of property is determined depends on the purpose for which the valuation is required. For a property transaction, the vendor and purchaser are interested, for example, on an appropriate market value, that is to say the "current value" (Verkehrswert) which complies with the current market ratio between supply and demand with regard to transactions for any specific type of property.

If the purchaser contacts a bank, so as to obtain a loan to finance the agreed purchase price, the bank must view the value of the property from a different aspect. Depending on the agreed period of repayment, the bank can foresee that it will receive full repayment of the loan normally only after 15, 20 or more years. For this period of time, the bank must optimally secure the repayment claim against the "value" of the property. It is therefore essential to estimate the value of the mortgaged property over a long period of time. This is provided by the determination of the mortgage value. These demands are not satisfied by other valuation terms, such as market value or current value. In view of the clear purpose of determining this value as the safe upper value for the long-term loan, this mortgage value is an autonomous value. In determining it, the safety requirements of the bank are dominant. In detail, this requires:

- The longest possible validity of the value with regard to future stability,
- The use of stable value components, derived from the market events of the past and present, as objective benchmarks, which are deemed as durable during the forecast period,
- The fulfilment of the requirements of the mortgage value with every comparable and value component used in establishing the value,
- The exclusion of all speculative components for future increases in value and profit,
- The taking into account of only the proven secured characteristics and income streams of the property at the time of the valuation, which could be consistently maintained with proper management by every owner of the valued property,
- The comprehensibility of the determined mortgage value with regard to all calculations, presumptions used and value affecting factors,
- The careful estimation of the future marketability of the particular property, both to a tenant and to a purchaser,
- The critical review of the adaptability for various uses or adequate functionality to third parties, as well as
- the listing of major, property related risks as the basis for the loan decision.

These components of the mortgage value as an independent, estimated value characterized by the principle of caution, is of importance not only when determining the value as the basis for loan decisions. In fact, this "mortgage value" is also a starting point in other sectors, in which the current value of the property in the event of a sale at the time of valuation is not of interest, but the careful assessment of a consistently achievable value. This applies, for example, for bank supervisory regulations regarding the necessary equity basis of property loans, which with regard to §§ 11 and 12 HBG specify a limitation to 60% of the effective value for mortgage purposes, as well as for the valuation of unutilized reserves from real estate values, which are accepted by the bank supervisory authorities as being the equity capital of a bank.

The stated components of the relevant mortgage value that are over and above the loan business sector, can be taken into account during the valuation with the aid of various, equally valid valuation processes. However, there can only be one definition of an autonomous mortgage value, which is the basis of these calculations:

II. Definition of the mortgage value

When determining the mortgage value, based on the basic conditions specified above, the following definition must be used as the basis:

The mortgage value of a property is the value that can be expected with a high level of surety, derived from the historic perspective of market events at the time of the valuation, on the basis of durable characteristics, and which will be achieved in normal property transactions over a long period in the future.

This perception of the mortgage value is based on the following definitions:

"Findings derived from the historic perspective of market events"	Secure, standard yardsticks based on experience, gained primarily from the interpretation and analysis of historic and current market developments, which are cautiously extrapolated with a critical estimation of the current situation and future risks.
"Durable future characteristics"	Factors and income streams which influence value and which are certainly sustainable at the time of valuation and which will probably continue to exist in the near future.
"A long period in the future"	The greatest period of validity possible, several years.
"Normal property transactions"	Unrestricted sale with a sufficient marketing period, under the precondition that the property market is neither extremely weak or strong; this excludes forced sale or compulsory purchase measures.

III. Future importance of the determination of the mortgage value

The methods and terminology for determining the mortgage value according to § 12 HBG gains increased importance. In this regard, various developments interact:

- It must be initially stated, that a legal development has occurred in Germany, in which apart from the term "mortgage value", a number of other terms have arisen. In fact, HBG (Mortgage Bank Act) and KWG (Banking Law) refer in principle to the "mortgage value". However, with the implementation of the Large-Scale Loan Directive, an additional term was introduced in the KWG, that of the "Real Property Value" (Grundstückswert). To a certain extent it is confusing that § 7 Para. 7 Building Society Law is virtually identical with § 12 HBG, however the mortgage value is defined by means of a legal definition as "the adopted value of the pledged property at the time of the loan", and the lending limit is expressly determined by the "market value". By comparison, § 12 HBG uses the additional term "sale value" (Verkaufswert). Until recently, depending on the purpose, the Insurance Supervision Law used the term "mortgage value" in line with the Mortgage Bank Law and the term "market value". Due to the requirements in EU law concerning the drawing up of balance sheets for real property, the insurance law regulations have now also incorporated the terms "present value" and "market value".

In view of this continual fragmentation in German law, it appears to be essential to urge a future, clear differentiation exclusively between the "mortgage value" on the one hand, and the "market value" on the other.

- In addition, there are the current initiatives at EU level; in addition to the procedures for determining the "market value" established with the Insurance Directive, as a parameter for the balance sheet estimation of the "Present Value" (Zeitwert) of real property, independent principles for the valuation of real property determined by application of a principle of caution are to be determined for the relevant area of loan transactions within the bank supervision legislation. Inasmuch, starting from the philosophy of the mortgage value, it will be necessary to seek ways for an agreement in Brussels, that will subsume the diverse national valuation methods under an abstract definition. Through European associations of valuers, the Chartered Surveyors are trying to submit uniform valuation standards into the discussion at an EU level, possibly in the context of the current amendments in the solvency directive for the future weighting of MBS and commercial loans against real property.
- Also as a consequence of the European harmonization process, the property valuation sector in Europe is currently going through a process of change. For Germany, in addition to the swearing-in of valuers, there will also be a more widespread appointment of examination bodies, that will be authorized to issue specialist certificates. In order to maintain here the standards for valuation of real property at the high level required for long-term finance business, the foundations need to be laid of the guidelines for determining the mortgage value.

Based on these developments, the "Mortgage Value" (Beleihungswert), as the target for real property valuation according to § 12 HBG, will in future have to be viewed within the context of the following concrete definitions and guidelines:

- a) The term "sale value" in § 12 HBG will be replaced by the term "mortgage value", since both terms are identical in content.
- b) The determined mortgage value, its parameters and the methodology to be applied, will be defined in a comprehensible manner.
- c) This does not result in a change in the existing distribution of responsibilities and powers within mortgage banks.

IV. Clarification of the difference between the mortgage value and the market value

1. Mortgage value

The mortgage value is an independent value with a clearly defined purpose:

- a) The "appraised mortgage value" (= "sale value" according to § 12 HBG) is the value determined for the purposes of the mortgage loan.

The APPRAISAL by the valuer is used to estimate the durable upper limit of value.

- b) The "adopted mortgage value" (= "mortgage value" according to § 12 HBG) is the adopted value when the loan is granted.

This ADOPTION is made in the process of the specific credit decision by the Managing Board of the respective credit institution.

The criteria for determining and specifying the mortgage value is specified by § 12 HBG. Accordingly, the mortgage value is the value achievable over a long period of time, which the asset on which the loan is granted has at the time of the valuation. Standard-setting terminology are "durably achievable income streams for every owner" and "durable property characteristics". The determination of the mortgage value is therefore not directed at the determination of the current price; in fact it is the reliable and durable adopted value during the set, long period of time that applies. For this reason, only value factors may be taken into account, which are in all probability stable on the basis of the past and present market experience.

Calculation of the mortgage value is done according to principles of content and methodology, which are laid down in general valuation guidelines and additional internal lending directives. The major element in the determination of the mortgage value is the principle of reviewing the pertinent, current local prices, yields and costs on their determining factors for all relevant value components, to make adjustments in this for the critically assessed circumstances, that is to include reductions in the computations, which are to be expected in future on the basis of the experience gained in the past. This involves therefore individual, plausible value presumptions for the future, whereby through their documentation, an adequate possibility must be established for a review of the individual components.

In relation to domestic transactions, the so-called "Two Column Principle" provides just such a control instrument. According to this, the "adjusted replacement value" (Sachwert) and the "income capitalization value" (Ertragswert) are independently determined. Noticeable deviations between both values must be taken into account on the basis for determining the mortgage value. Apart from the owner-occupied housing sector, the income capitalization value regularly forms the upper limit for the mortgage value. By comparison to the determination of the "market value", when calculating the income capitalization value, there is a prescribed spread between the upper and lower limits when estimating the management costs or yield, whose lower values are normally deemed to be the minimum rates. They are derived from past experience and are used for the safety requirement, in that they should virtually exclude losses in value from future market fluctuations.

Under normal circumstances, the "market value" represents the ceiling for the mortgage value. At the low point of a recession, it can however be acceptable that the mortgage value can be above the lower market value currently achievable in the market. A mortgage value determined by means of conservative valuation benchmarks does not require any subsequent evaluation, unless specific information arises that could have a negative effect on the loan security.

2. Market value

The market value is a value determined for a specific point in time. Its definition in BauGB (German Building Legislation) is supplemented by detailed valuation regulations (Valuation Directive and Valuation Regulations).

§ 194 BauGB states: "The market value is determined by the price that could be achieved at the time to which the valuation refers, in normal business according to the legal stipulations and actual characteristics, the other attributes and the location of the real estate without taking into account unusual or personal circumstances."

This regulation is based on the direct legislative interest in the determination of the market value as the "correct" current value. Accordingly, the market value forms the basis for compulsory purchases, legal purposes and other property disputes, etc. As a result of this designation, the market value is only valid for a short period.

Based on this multifarious purpose, the market value is taken to mean the value that would most probably be achievable on the day of the valuation in the course of normal business. Experience has shown that such values are subject to considerable fluctuations, depending on the tendencies that were dominant in the property market on the critical valuation date, and the expected returns forecast for the future. In times in which a "sellers market" is dominant (insufficient property available, large demand), the purchase prices of comparable properties are regularly higher than at the time of a "buyers market" (large range of property available, low demand). The price formation is included in the determination of the market value, which is subject to considerable fluctuations.

V. Method of determining the mortgage value

1. Valuation for mortgage loans on domestic properties

The main parameters for the mortgage value are summarized in the following list:

1. The valuation is always obtained on the basis of the “adjusted replacement value“ (Sachwert) and the “value investment“ (Ertragswert) ("Two Column Principle"). Comparative values can be consulted in suitable cases as, for example, when determining the land value and the value of freehold flats suitable for owner-occupation.
2. When determining the value in terms of building cost as part of the adjusted replacement value, in view of the future orientation which characterizes the determined mortgage value, in accordance with the precautionary principle, deductions must be made from the building cost ("reduced building cost").
3. The ancillary construction costs of a construction project, may only be listed as a part of the actual building costs up to an acceptable maximum rate. Accordingly, a reimbursement of the total costs incurred is normally impossible to regain in the event of a third party purchase. The finance costs are taken into account in the ancillary construction costs.
4. Only durable, customary local net rents may be included in the calculation of the income capitalization value. The primary starting point here consists of the current, customary local market level. Additional receipts over a limited period (overrent) may not however be taken into account when determining the mortgage value.
5. Minimum rates must be taken into account for those maintenance costs borne by the lessor. In the detailed determination of the maintenance costs as part of the customary normal expenditure, a minimum level should not be undercut in relation to the “net cold rent“ (net rent). Alternatively, lump sum maintenance costs can also be listed. In this case, the normal maintenance costs that are typical for the building, serving as security, shall not be undercut.
6. The capitalization of the net rent must normally be carried out within specific fluctuations in the yields, whereby the lower fluctuation value is typically deemed to be a minimum capitalization interest rate, which is looked at differently for residential and for commercial property. Depending on the location, the type of use, property condition, letting and usability, an individual benchmark should be used with regard to higher rates, according to the typical risk for the property.
7. When estimating the durable value of the property, its multiple purpose suitability or adequate use by third parties, must be reviewed.
8. Major realty related lending risks are to be expounded as the basis for the lending decision.

9. On all properties for which during the determination of the market value, rights are registered in Division II of the Land Register (Grundbuch) which affect the value (rent for heritable building rights, life annuities or annuities for specified periods, residential rights, etc.), an autonomous standard arises for determining the mortgage value. Due to the importance of the ranking of the rights in rem, in principle, the mortgage value must be determined free of such Division II charges. These monetary rights must be separately assessed, since a decision is taken on the granting of the loan on the basis of the ranking that arises for the rights in rem of the credit institute based on these figures.
10. For the determination of the mortgage value, only valuers, as well as suitable employees, may sign, who have the necessary qualification in the sector of mortgage valuation, can verify that they possess adequate experience and are known to be trustworthy by the bank. A simplified valuation procedure, without the preparation of a formal specialist report is possible up to the so-called small loan limit, provided suitable organisational precautions and controls give an assurance of an adequately safe valuation.
11. For mixed properties, the separation of the income capitalization value is essential, on the basis of the elements used for residential and for commercial purposes.
12. During the determination of the mortgage value, the valuer must carry out an evaluation of the current marketability of the property (lettability and usability).

2. Valuation for mortgage loans on property abroad

Up to now there are no EU uniform valuation regulations. The banks can use reports that are prepared in accordance with the accepted, country specific valuation procedures. When reviewing the plausibility of these reports, it must be ensured that the results comply with the basic criteria of the mortgage value as listed under I and II. The German mortgage banks intend to submit the core elements of the mortgage value specified in I and II, which contain its philosophy and its definition, in the forthcoming European discussion.

Final remark

The above mentioned basic findings cover the major elements concerning the method of determining the mortgage value, they cannot however cover the entire subject and thus do not claim to be complete. Additional questions on the details are still under discussion, e.g. the level of the minimum capitalization factors, the permissibility of the basis of overhead free rentals and the associated, reduced specific management costs, as well as the specific procedures for determining the mortgage value for foreign properties.