APS 220 Credit Risk Management

Submission to the Australian Prudential Regulation Authority
June 2019

Introduction

The Australian Property Institute (API) has prepared this submission in response to the Australian Prudential Regulation Authority's (APRA) – *APS 220 Credit Risk Management* Discussion paper, 2019 (APS 220).

As we stated publicly during 2018, we remain appreciative of the valuable and diligent work undertaken by APRA to date throughout its discussion paper. In particular we appreciate the way APRA remained focused on its task, despite the political pressure and – at times – extraordinary circumstances that have attended the scrutiny, and passage, of the legislation.

Our submission offers comments and suggestions in relation to the Government's amendment to the changes to the APS 220 discussion paper and we urge APRA to consider the following recommendations

In drafting this submission, the API have drawn from a range of sources, including the views of the members who have been involved in our scrutiny of the APS 220. The API is home of some 8000 property professionals operating across the valuation, banking, property finance, commercial leasing and development, and property asset sectors across all classes within the Australian economy.

The API have focussed on what we see as the most useful and constructive elements of the proposed amendments.

The API reiterates its concern that in general, the impact of this legislation on valuers has not been sufficiently considered. The general term 'external event' is too broad and must be further interrogated.

Furthermore, the ability of Banks and valuers to access relevant data may impact Australian Businesses and Government agencies and leave them in breach of the APS 220 guidelines. It is unclear how this will be monitored and addressed.

The API commends APRA and the Government for the changes that have already been handed down by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The API recommends that APS 220 be further amended to ensure that the far-reaching powers afforded in the legislation are only applied where necessary and within clearly defined boundaries that take into account the potentially competing requirements.

Fair Value vs Market Value discussion

APS 220 uses the term 'fair value' throughout and paragraph 81 notes *"the valuation of collateral must reflect fair value (in accordance with Australian Accounting Standards), taking into account prevailing market conditions such as time taken for the liquidation or realisation of collateral."*

Collateral includes real property and non-real property and the valuation of such collateral by the ADI must reflect 'fair value'. Fair Value is a defined term in the International Valuation Standards (IVS 2017), the International Financial Reporting Standards (IFRS 13) and Australian Accounting Standards (as published by the AASB).

Fair Value is defined in IVS 2017 and IFRS 13 as *"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."* (IVS 2017 – General Standards – IVS 104 Bases of Value, paragraph 90.1)

API Members are instructed by ADIs to undertake the valuation of real property and provide their opinion as to the 'market value' of the subject property as at the date of inspection/valuation. Market Value is a defined term under IVS 2017;

"Market Value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller where the parties had each acted knowledgeably, prudently and without compulsion," (IVS 2017 – General Standards – IVS 104 Bases of Value, paragraph 30.1)

Valuations provided by API Members will be on a market value basis as per the ADIs instructions, API professional obligations (the Australian & New Zealand Valuation and Property Standards including Guidance Notes and TIPs and any other documentation published or adopted by the API and applicable at the date of valuation), as well as the IVS 2017 published by the International Valuation Standards Council. The IVS has been adopted by the API in full and is the overarching global document that sets out the principles for the valuation of property.

In order to comply with APS 220, the ADI will need to determine the *"fair value (in accordance with Australian Accounting Standards)"* of the collateral based on the information contained in the valuation reports provided by API members and the requirements under APS 220 including Attachment A – Collateral and security valuation, paragraph 3 (a) to (d).

Item (d) notes that the ADI must have regard to *"costs which would arise in accessing and disposing of assets held as collateral."* This would need to be an internal calculation by the ADI, as the API member is not privy to the accessing, holding and selling costs (including taxes) that the ADI is subject to when it disposes of collateral. The IVS 2017 discusses transaction costs under General Standards - IVS 104 Bases of Value, paragraph 210.1;

"Most bases of value represent the estimate exchange price of an asset without regard to the seller's costs of sale or the buyer's costs of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction."

Suggested Amendments

We recommend that the following amendments be incorporated into the APS 220 standard as soon as possible, i.e. prior to the statutory review of the legislation by APRA. Please refer to the table below for a more detailed list of suggested amendments and for further explanations of the items listed in the bullet points below.

- The AASB referral to highest and best use below potentially contradicts APRA's reference to existing use.
- External events in APS 220 are aligned to weather events. However, bio-security matters, the USD/AUD conversion, activism against intensive animal production or processing facilities are also potential external events that would have a significant effect on asset values and thus should be included as external events.
- The APS 220 discussion paper uses the term 'external events'. This term is too broad, API suggest a more precise notation of the term.
- The wording '*likelihood of*' should be reviewed and changed to '*known or foreseeable external events'.*

APS 220 paragraph 46 – Page 11

"46. An ADI must have prudent credit risk policies covering the acceptability of various forms of collateral, appropriate processes for the valuation of such collateral (including the valuation of collateral prior to entering into an exposure and the ongoing valuation of collateral, where appropriate), and an appropriate process to ensure that collateral is, and continues to be, enforceable and realisable (refer to Attachment A)."

- This paragraph requires a 'valuation' to be undertaken prior to lending by an ADI and during the term of the loan.
- 'Valuation' includes not only what we would term as a full inspection valuation, but also 'alternate valuation methods' which are noted in paragraph 8, of Attachment A (page 23) which notes; *"8. If an ADI relies on the use of alternative valuation methods such as desktop assessments, kerbside assessments and automated valuation methods, …"*
- Valuations, desktop assessments and kerbside assessments are all conducted by API members. API members provide their services to ADIs in accordance with the API professional obligations (the ANZVPS including guidance notes and TIPs and any other documentation published or adopted by the API), and the International Valuation Standards (IVS) published by the International Valuation Standards Council (IVSC) applicable at the date of valuation. The IVS has been adopted by the API in full and is the overarching global document that sets out the principles for the valuation of property.
- The API agrees with the examples provided as 'alternative valuation methods' as this distinguishes then from a 'valuation' which is subject to a full inspection and additional research and reporting, as opposed to a 'desktop assessment' or 'kerbside assessment'.
- An 'automated valuation method' is normally generated by a system based model without the input of an API member.

APS 22 paragraph 81 – Page 15

"81. An ADI must have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral must reflect fair value (in accordance with Australian Accounting Standards), taking into account prevailing market conditions such as time taken for the liquidation or realisation of collateral. In the case of agricultural land taken as security, an ADI must also ensure the valuation takes into account the likelihood of external events, such as drought and flood, which may impact the valuation of the land."

The API sees there are several items under paragraph 81 that require addressing. The API recommends that this paragraph be broken into 3 separate items.

1. "An ADI must have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral."

- The above outlines that the ADI must undertake valuations of various items collectively referred to as 'risk mitigants'.

2. *"The valuation of collateral must reflect fair value (in accordance with Australian Accounting Standards), taking into account prevailing market conditions such as time taken for the liquidation or realisation of collateral."*

- Collateral includes real property and non-real property and the valuation of each must reflect 'fair value' (a defined term in IVS 2017 under IFRS 13 (International Financial Reporting Standards) and Australian Accounting Standards as published by the AASB.
- Fair Value is defined in IVS 2017 and IFRS 13 as *"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."* (IVS 2017 – General Standards – IVS 104 Bases of Value, paragraph 90.1)
- API Members are instructed by ADIs to undertake the valuation of real property and provide their opinion as to the 'market value' of the subject property as at the date of inspection/valuation. Market Value is a defined term under IVS;
- *"Market Value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller where the parties had each acted knowledgeably, prudently and without compulsion"* IVS 2017 – General Standards – IVS 104 Bases of Value, paragraph 30.1
- The ADI will need to determine the *fair value (in accordance with Australian Accounting Standards)* internally and in keeping with the requirements under APS 220 including Attachment A – Collateral and security valuations, paragraph 3 (a) to (d).

3. *"In the case of agricultural land taken as security, an ADI must also ensure the valuation takes into account the likelihood of external events, such as drought and flood, which may impact the valuation of the land."*

- This relates solely to the valuation of agricultural land and comes from Recommendation 1.12 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

- ‘Agricultural land’ is not defined and may be open to interpretation. From an API perspective, we advise that the role of the valuer in assessing market value and identifying and reporting on risk issues is applicable to all mortgage valuations and the discussion below will be of a general nature as it applies to all mortgage valuations undertaken by API members.
- One of the roles of the valuer when undertaking a valuation for mortgage and loan security purposes is to provide their opinion as to what the most likely sale price would be if the asset(s) was offered to the market – for sale – as at the date of valuation. Another important role is identifying and reporting on risk issues which are observed at the time of the inspection or publicly known issues that could have an impact on the value and/or marketability of the property.
- The API suggests that this item be reworded to remove reference to ‘agricultural land’ and include all property types e.g.; *“The ADI must also ensure the valuation takes into account the known of foreseeable external events, which may impact the valuation and marketability of the land.”*
- A *“… valuation (that) takes into account the likelihood of external events, …”*. The valuer is required to identify and report on known or foreseeable risk issues (property and market related issues including but not limited to, environmental issues, aka ‘external events’). In addition to providing their opinion of the market value of the property, the valuer should advise the lender (ADI) of any factors that could impact adversely on the property as a security. This may include those factors, which, assessed on information that is common knowledge, readily ascertainable in the market and/or reasonably foreseeable and may have an adverse impact on the value and/or marketability of the property.
- Valuers include environmental issues sections in their reports which cover a wide range of issues including observable, visual and/or known effects, hazards or site contamination. If the property which is the subject of the valuation is in a known bushfire, cyclone, flood or subsidence etc. location, then the valuer would note this in the report as a statement of fact.
- For example, in the case of a property that is in an area subject to a drought event, the valuer should note that the property is in a proclaimed drought area. The sales evidence in the locality, that the valuer relies upon, is also usually impacted by the same environmental issue and therefore reflects the market’s perception of the environmental issue (‘external event’). The assessed market value is the valuer’s interpretation of the current market value based on sales evidence and the prevailing market conditions and sentiment, as at the valuation date. This situation is also true for bushfire prone areas where properties are similarly affected (although some more so than others).
- If there is a known issue coming that the market is aware of, then this is often reflected in the sales evidence available and/or factored into the valuer’s assessment of the current market value.
- If the ‘external event’ is a sudden event, such as a bushfire, flood or cyclone then there will be no sales immediately following the ‘external event’ (disaster) as no one is able to sell (or willing to buy) whilst the clean-up and rebuilding phase is occurring. The likelihood of any such event occurring is unknown (although the risk of such events (cyclone and bushfire for instance) occurring in specific locations is increased during certain periods of each year) and would not be able to be accurately predicted by the Valuer (or anybody else).
- The valuer is not able to predict when an ‘external event’, such as a bushfire, flood, cyclone, storm damage, erosion, mine subsidence, or unknown source of contamination (e.g.; gas leak, PFAS, ground water contamination) will occur and unless the market is factoring in such potential events then this will not be reflected in the sales evidence (prices) or the assessed market value.

- Forecasting climate events is not the role of a valuer. Most firms would already provide historical climate commentary and rainfall data to various degrees, where applicable to the property valuation being undertaken.
- The valuer is also not predicting future market levels or market conditions, that is, not providing a future value.
- The wording *'likelihood of'* should be amended and changed to *'known or foreseeable events"*

The API proposes that paragraph 81 be split into three sections eg.:

81. An ADI must have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral.

(a) The valuation of collateral must reflect fair value (in accordance with Australian Accounting Standards), taking into account prevailing market conditions such as time taken for the liquidation or realisation of collateral.

(b) The ADI must also ensure the valuation takes into account the known or foreseeable external events, which may impact the valuation and marketability of the land.

Attachment A – Collateral and security valuation

Attachment A paragraph 2 - page 21

"2. Valuation of security must be undertaken on any exposure prior to drawdown and, where appropriate, an on-going basis."

The API agrees that this is good news as it requires collateral to be valued prior to the advancement of funds. API members are the experts in providing valuations for ADIs in these situations.

Attachment A paragraph 3 - page 21

"3. In the event that the fair value of security is based on observable market values, an ADI's policies and processes must have regard to:

(a) when observable market prices would be used;
(b) the basis for selecting the market prices to be used;
(c) the impact of market liquidity on the pricing of assets and the timing of their disposal; and
(d) costs which would arise in accessing and disposing of assets held as collateral."

'Fair value' has been discussed previously.
This paragraph relates to the ADIs internal assessment on a fair value basis. The valuer will provide a market value assessment in accordance with API requirements (including IVS) and the ADI can then undertake an internal review to confirm its position in accordance with fair value (as per AAS) and requirements under APS 220.

Paragraph 3 (d) notes that the ADI must have regard to *"costs which would arise in accessing and disposing of assets held as collateral."* As noted previously this is an internal calculation that the ADI will need to make, to ensure reporting of its security position back to APRA is in accordance with the Prudential Standard.

Attachment A paragraph 5 - page 21

"5. In determining the fair value of security, an ADI may utilise the valuations of suitably qualified internal appraisers, external valuers or automated valuation methods. Policies and processes covering the fair value of security must address the circumstances in which such valuations would be sought."

API members who hold CPV/RPV certifications would be 'suitably qualified internal appraisers or external valuers'. An automated valuation method is carried out by a computer system based on data and a mathematical model.

Attachment A paragraph 8 - page - 22

"8. If an ADI relies on the use of alternative valuation methods such as desktop assessments, kerbside assessments and automated valuation methods to produce a security valuation, it must have appropriate policies and processes which address:

(a) when valuations would be provided by the alternative method;
(b) monitoring, validation and reporting of valuation data; and
(c) asset values including adequate cuts for conservatism when using automated valuation methods."

The 'alternate valuation methods' noted are either conducted by API members, in the case of desktop assessments and kerbside assessments, or a computer system in the case of automated valuation methods. API members conduct desktop assessments for ADIs in accordance with the API Residential Desktop Assessment – Memorandum for First Mortgage Purposes (effective 1 October 2016) and kerbside assessments are completed in accordance with API Restricted Assessment Supporting (effective 1 July 2014) – note these API documents may (and will) be updated and republished over time.

Attachment A paragraph 12 - page 23

12. If an ADI uses valuations in determining the fair value of collateral, the ADI must require valuers and appraisers, in preparing their valuation reports, to adopt the valuation standards and practices of any relevant professional bodies. For example, in the case of property valuations, the standards and practices of the Australian Property Institute or equivalent local or offshore bodies must be used. Valuation reports must be based on the standard format advocated by any relevant professional bodies.

- In the case of a residential property valuation, these would be undertaken (in most cases) using the API PropertyPRO Residential Valuation and Security Assessment Pro-Forma Supporting Memorandum (PPSM) (effective 1 September 2016).

Attachment A paragraph 15 – Page 23

"Valuation of security in the form of property

15. For the purposes of determining the fair value of security involving property, an ADI must assume:

(a) a property would be accessed in the near future;
(b) the period for marketing a property would be up to 12 months, although a longer period (up to a maximum of 24 months) may be adopted for specialised or unusual properties when professional valuers advise that this is appropriate; and
(c) market conditions and asset values remain static over the marketing period. Marketing periods must be retrospective and assumed to have elapsed at the date of valuation, rather than incorporating any improved market conditions."

(a) a property would be accessed in the near future;

- The API advises that this is the basis that the market value assessment is carried out by API members – that is, the property is offered to the market, for sale, as at the date of valuation/inspection.
- As noted previously, the role of the valuer is to provide their opinion as to what price the subject property would likely resell for if offered to the market as at the date of valuation, that is, a hypothetical transaction as at the date of valuation/inspection, which meets the IVSC definition of market value and is supported by appropriate valuation methodology.

(b) the period for marketing a property would be up to 12 months, although a longer period (up to a maximum of 24 months) may be adopted for specialised or unusual properties when professional valuers advise that this is appropriate;

- All ADIs standing instructions should require the valuer to provide an estimated selling and or marketing period to achieve the assessed market value. If the valuer states that the 'estimated selling period' is greater than 6 or 12 months (depending on the ADIs instructions) then the ADI will need to request the valuation report and include an additional assessed value subject to a special assumption.

(c) market conditions and asset values remain static over the marketing period. Marketing periods must be retrospective and assumed to have elapsed at the date of valuation, rather than incorporating any improved market conditions.

- The assessed market value is based on sales evidence and the prevailing market conditions as at the date of inspection/valuation. The property is assumed to be offered for sale in those same market conditions. Those market conditions are known and may or may not have been static in the lead up to the valuation date. The API is assuming that statement; 'Marketing periods must be retrospective and assumed to have elapsed at the date of valuation' which would link the assessed market value and the estimated selling period to what is known, and has occurred up to the date of valuation

Attachment A paragraph 16 - page 24

"16. Property assets must, unless otherwise agreed with APRA, be valued on the basis of existing use. Any higher value related to an alternative use arising from prospects of redevelopment, and any possible increase in value consequent upon special investment or finance transactions, must be disregarded. In determining values based on existing use, an ADI must use conservative estimates in imputing future income streams, such as lease payments which are not already contracted."

- There is an issue with only valuing on the basis of the existing use, unless otherwise agreed with APRA.
- API members are required to value assets on a highest and best use basis as detailed in IVS 2017, API would suggest that APRA incorporated the following IVS General Standards into APS 220
  - IVS 2017 – General Standards – IVS 104 Bases of Value notes at paragraph 30.4;
    - *"The Market Value of an asset will reflect its highest and best use (see paras 140.1 – 140.5). The highest and best use is the use of an asset that maximises its potential and that is possible, legally permissible and financially feasible. The highest and best use may be for continuation of an asset's existing use or for some alternative use. This is determined by the use that a market participant would have in mind for the asset when formulating the price that it would be willing to bid."*
  - Paragraphs 140.1 to 140.5 of IVS 104 Bases of Value provide further explanation about the concept of highest and best use.
  - Paragraph 150.1 of IVS 104 Bases of Value states;
    - *"Current use/existing use is the current way an asset, liability or group of assets and/or liabilities is used. The current use may be, but is not necessarily, also the highest and best use."*
- We note that paragraph 16 does have an exemption that can be provided by APRA for assets to be valued on "an alternative use resulting from prospects of redevelopment,"
- It would be prudent for the APRA exemption to be requested by ADIs so that assets could be valued on a highest and best use basis where appropriate.
- The other consideration is for 'as if complete' valuations of proposed developments. If only the 'existing use' can be valued and redevelopment (construction of a proposed dwelling or factory) "must be disregarded" then the valuation for ADI will only be able to be returned at the value of the existing property, which may be vacant land, or a derelict building etc).
- The API suggests that this paragraph should be re-worded along the following lines;

16. Property assets must be assessed on a highest & best use basis. Where the highest & best use differs from the existing use the valuation must include assessments on both the highest & best use basis and on the existing use basis. The ADI must report the fair value on an existing use basis, ignoring any higher value related to an alternative use arising from prospects of redevelopment, and any possible increase in value consequent upon special investment or finance transactions must be disregarded. In determining values based on existing use, an ADI must use conservative estimates in imputing future income streams, such as lease payments which are not already contracted."

Conclusion

As highlighted in our submission, the API believes that these amendments to the *APS 220 Credit Risk Management, 2019* will ensure that the legislation does not weaken existing ADI credit portfolios and that it balances security and privacy whilst minimising unintended consequences.

The API looks forward to continued engagement with APRA, financial institutions and other relevant stakeholders on the mutual objective to protect Australians from credit risk.

The API values the opportunity to discuss the suggested amendments contained within our submission. We welcome any prospects to strengthen API's relationship with APRA going forward.

For questions relating to this submission please contact:

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References

APRA (Australian Prudential Regulation Authority) (2019), Discussion paper - APS 220 Credit Risk Manager – May 2019. Available at https://www.apra.gov.au/sites/default/files/discussion_paper_aps_220_credit_risk_management_march_2019_v1.pdf