

NATIONAL
BANK OF
POLAND

COMMISSION FOR
BANKING
SUPERVISION

General Inspectorate of Banking Supervision

RECOMENDATION F

of November 12, 1998
on the basic criteria
used by the Commission for Banking Supervision
to evaluate mortgage banks'
appraisal procedures

Warsaw, 1998

COMMISSION FOR
BANKING
SUPERVISION

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Presidents of all Banks

The Law on Mortgage Banks and Mortgage Bonds became effective as of January 1, 1998. The rules regulating the operations of mortgage banks in Poland were contained in a law separate from the Banking Law. The lawmaker intended this way to unequivocally and clearly present the rules under which they operate, and stressed their nature as specialist banks.

This law sets forth the rules and requirements, which the mortgage banks have to meet to operate, and introduces a concept of "mortgage lending value" hitherto unknown in Polish law. It describes it as a value adopted by a mortgage bank to secure a loan made.

Mortgage banks should be particularly careful in appraisal of real estate which serves as collateral for their receivables, due to the special nature of their of their activity and their concentration in an area connected with one kind of risk (real estate market). It was the lawmaker, who put on the bank supervisors the duty to approve the mortgage banks' internal appraisal procedures, to assure a high quality of the banks collateral (according to article 22 section 2 of the above mentioned law, the Commission for Bank Supervision was obligated to approve the appraisal procedures issued by mortgage banks). It was intended to limit the banks freedom to chose any given appraisal methodology, thus limiting the risk associated with it. The General Inspectorate of Banking Supervision has therefore undertaken appropriate measures to develop a document recommending basic criteria used by the Commission for Banking Supervision to evaluate the appraisal procedures issued by mortgage banks. Issuing this regulation, the Commission for Banking Supervision intends to indicate what philosophy and direction of conservative appraisal methodology the mortgage banks should use. This philosophy and direction should be applied to the detailed appraisal procedures submitted to the Commission for approval.

In GINB's opinion the appraisal method of the long term receivables portfolio collateral should be treated as a particular "prudential norm" for mortgage banks. The solutions adopted are based on article 22 section 1 of the above mentioned law. They are comparable to the solutions which have been proven in countries with a long lasting tradition of mortgage banking.

The recommended approach to mortgage lending value appraisal was based mainly on the factors derived from information obtained from the market. Because of this, it is strongly recommended to exercise particular caution when selecting and evaluating them, especially in the Polish conditions. Therefore it is necessary for the mortgage banks to conduct a broad market analysis (not just the real estate market). The results of such an analysis shall make it possible for mortgage banks and other interested institutions to create appropriate data bases to allow for the performing and controlling the appraisal.

Because of its importance, the above mentioned recommendation was consulted and discussed with Polish and foreign experts representing the real estate market and the mortgage banking industry. The representatives of the German supervisory institution and the German appraisers cooperating with the mortgage banks expressed their opinion during the consultations process, as well as American appraisers, representatives of the Polish and American academic community and the German licensing institution for mortgage lending value appraisers. The discussions confirmed the lack of clear and

uniform international guidelines regarding the methodology of real estate appraisal for the purposes of securing long term bank receivables. There is an ongoing discussion regarding this matter in many countries with developed real estate markets. This discussion has resulted so far only in agreement on the minimum criteria which should be considered in appraising real estate for the purposes of securing long term bank receivables. The following recommendation contains, among others, those minimum criteria considering the specifics of the Polish market.

Attached we are sending Recommendation F, which intends to assist mortgage banks in the development of their internal appraisal procedures and, most of all, to indicate the form most desirable by the Commission for Banking Supervision.

Hanna Gronkiewicz-Waltz, Ph.D.

Recommendation F

of November 12, 1998

on the basic criteria used by the Commission for Banking Supervision to evaluate mortgage banks' appraisal procedures

The determination of mortgage lending value, as a long term value accepted by a mortgage bank to secure a credit should be performed with due diligence. In particular it should consider only the features of the real estate and the income derived therefrom, which are, assuming rational maintenance, permanent in nature and which are obtainable by any owner of the real estate.

Mortgage lending value is determined based on the recognizable and quantifiable risks.

Detailed rules for real estate appraisal, on which the mortgages securing bank receivables are established, should be determined in the appraisal procedures issued by mortgage banks.

When evaluating the applications for approval of the detailed appraisal procedures submitted by the banks¹, the Commission for Banking Supervision shall verify whether these procedures include the recommended general characteristics of the careful appraisal of real estate for the purposes of securing mortgage banking receivables.

I.

General Conditions

1. Mortgage lending value is determined for all real estate which secures a bank credit.
2. Mortgage lending value is determined in a bank, by authorized persons, based on a written document prepared by a bank designated appraiser. The criteria of the appraisers selection are set by the bank in the real estate appraisal procedures.
3. The appraiser shall perform the internal and external evaluation of the real estate before rendering a written opinion. This opinion shall contain a proposed mortgage lending value, clear methodology of how the value was arrived at and other information, in particular
 - a) the date of the appraisal,
 - b) list of sources of information available on the market, which could be applied to the appraised real estate, and which were used by the appraiser (in particular a zoning plan for the given area),
 - c) legal status of real estate (including information on possible use of the real estate as a bank loan collateral),
 - d) the description of appraised property and its kind (together with photographs and appropriate blueprints),
 - e) the description of additional internal and external technical equipment which constitutes a part of the appraised property,
 - f) an evaluation of a long term possibility for the sale, rent or an alternative legal use of the property – together with the rent or lease income prevailing in the area.
4. The appraiser prepares a written appraisal in a clear manner to allow the employees of the bank for reconstruction and verification of the appraisal process.

¹ Based on article 22 section 2 of the Law on mortgage bonds and mortgage banks of August 29, 1997.

5. The parameters selected for consideration during the appraisal shall be realistic and capture the long term influence of various factors on the value of property. However, these factors are considered, providing their careful and critical consideration, only when they have a historically proven, long lasting effect on safety. All the factors which could be considered speculative shall be excluded.
6. The comparison of parameters regarding a given property shall always be performed in relation to the average permanent market value of similar property. The starting point to determine a given permanent market average shall always be the (average) market relationships typical to a given area, which were prevailing at the time of the appraisal. However they should be evaluated particularly carefully from the standpoint of risk both in the long term historical perspective and in the aspect of their long term existence (safety) in the future.
7. The appraisers, both employed by the bank and independent outside appraisers, shall be independent in their activity and shall perform their duties impartially and with due diligence. An appropriate statement regarding these qualities shall be attached to the appraisal of mortgage lending value prepared by the appraisers.
8. The amount of the appraisers remuneration can in no way be connected to the value of the appraised property.
9. The ultimate mortgage lending value is set (approved) by the bank's management board or a person (or organizational unit of the bank) delegated by the board.

II.

Procedures of arriving at the mortgage lending value.

The process of appraising the mortgage lending value of a property shall independently utilize the following two approaches: the income approach and the cost approach (replacement cost). The results of this analysis shall become a fundamental auxiliary element in appraising the mortgage lending value. For comparison and control purposes, the appraisal shall additionally present the bank with the current market value (transaction price) at the time of the appraisal for a given type of property (comparable to the appraised property) in the area of the appraised property.

1. Income approach

1. The level of permanent gross income from a given property (fixed rent, typical for a given area and a given location), which is obtainable on the market by any owner of such property shall be established based on all the usable information from all the possible sources and based on the experience possessed. Such an analysis considers, in particular, the following:
 - a) the type of property (its attractiveness, architecture, etc.),
 - b) its location,
 - c) additional equipment (both internal and external),
 - d) current and alternative uses of the property,
 - e) local transportation and economy,
 - f) current and future market situation.
2. The rent rates which exceed the average prevailing rates for a given area (a permanent tendency) shall be decreased. The possibilities of various uses of the property shall be considered, when determining the average gross income from a given property (the uses by any other lessee or owner).

3. The permanent operating costs shall be subtracted from the average gross income. The individualized operating costs for a given property cannot become the starting point for the calculation. Rather the required long term typical operating costs of comparable, similar buildings, determined based on the available market data and the experience of the appraisers shall become the starting point for the calculation. The permanent, regular operating costs typical for a given property must not be understated. The operating costs consist, in particular, of administrative costs, maintenance costs, land tax and all other appropriate costs. The average market operating costs shall be increased appropriately to the age and condition of the buildings on a given property and the complexity of additional internal and external equipment.
4. The bank management determines the minimum level of flat rate operating costs² (expressed as a percentage of the permanent gross income value from a given property) for residential and commercial real estate, which shall be used in the calculation.
5. The Commission for Banking Supervision, in accordance with the rule of prudence (based on the article 34 section 4 of the Law on Mortgage Bonds and Mortgage Banks), may set the minimum required level of flat rate operating costs (expressed as a percentage of the permanent gross income from a given property used by the bank) for residential and commercial real estate to be used in the calculation.
6. Next, the resulting net income (obtained by subtracting operating costs from gross income) is capitalized. The starting point is the interest rate comparable to the capital market long term interest rate, which shall be increased depending on how permanent is the income from a given property, and all types of risks associated with a given type of real estate and the area of its location. The capitalization rate for commercial real estate is from the risk perspective always higher, than the capitalization rate for the residential real estate.
7. The bank Management Board sets the minimum capitalization rate level³ for commercial and residential real estate, which shall be used in the calculation.
8. The Commission for Banking Supervision, based on the rule of prudence (based on the article 34 section 4 of the Law on Mortgage Bonds and Mortgage Banks), may set the required minimum level of capitalization rate for residential and commercial real estate which shall be used in the calculations.
9. The length of the capitalization period shall be determined considering the remaining duration of economic and functional usage of the buildings on a given property. The length of the period shall be appropriately justified in the appraisal performed for the bank by the appraisers.
10. For mixed use property the income approach is used separately for the residential and the commercial part.

2. Cost approach (replacement cost approach).

- 1) The value of the building is determined based on the current, average market cost of its replacement, considering the level of appropriate charges associated with the building's technical (age), functional and environmental wear.
- 2) The separately appraised value of land is added to the value of the buildings. The appraisal of the permanent value of the land (the lot) is performed separately from the appraisal of the buildings, according to the comparative approach, based on the prices of the land (lots) of similar size, type, location, legal status, and based on historical transactions in the area (town or city). Specific

² Determined based on market data

³ Determined based on market data

location is of fundamental importance to the appraisal. The appraisal should consider all other factors, which could influence the value in the future (considering the provision of point 1.5), and resulting from, most of all, the zoning plan for a given area. The value of the land shall include the costs of improvement.

- 3) The result of the calculation (the sum total of the value of the land and the building) shall be decreased by an additional charge (expressed as a percentage) to limit the risk resulting from possible future price fluctuations.
- 4) The bank Management Board sets the minimum level⁴ of the charge which shall be used in the calculations.
- 5) The Commission for Banking Supervision, based on the rule of prudence (based on the article 34 section 4 of the Law on Mortgage Bonds and Mortgage Banks), may set the required minimum level of this charge, which shall be used in the calculations.

3. Mortgage lending value.

- 1) The ultimate mortgage lending value is determined by means of analysis of the results of the income and cost approaches (calculated separately).
- 2) In case of a discrepancy between the results of the income and cost approach (replacement cost approach) to the mortgage lending value the dominant role shall be played by:
 - the result obtained according to the income approach for commercial real estate (the result obtained with the cost approach shall have in such cases, as a rule, only a secondary meaning and shall be used for information purposes only),
 - the result obtained according to the cost approach for real estate used for residential purposes of the owner (the result obtained with the income approach shall have in such cases, as a rule, only a secondary meaning and shall be used for information purposes only).
- 3) The mortgage lending value of a real estate should not be higher than its current market value (transaction price) at the moment of appraisal and granting of a loan.
- 4) If there are legal possibilities of an alternative use of a particular real estate, the terms and conditions of such use shall be determined (necessary expenditures, time, etc.). If the value appraised by this method is higher than the value of the property under current use, than, as a rule, for prudential reasons, such value shall not be considered in the process of determining the mortgage lending value.
- 5) The arrival at the proposed mortgage lending value by the appraiser and its ultimate determination by authorized persons at a bank shall not be performed mechanically by means of calculations. In both cases long-term knowledge of the market, experience and realistic estimation of risk are decisive factors. Therefore, the results of all calculations shall be adequately checked in accordance with the requirement specified in paragraph I, subpara.4 on the transparency of the appraisal.

III

For particular, partial mortgage market segments, simplified valuation procedures with the use of a comparative approach may be introduced in the future, depending on adequate justification of such introduction and approval by the Commission for Banking Supervision.

⁴ Determined based on the market data.

IV

A new appraisal of value and new determination of the value by the bank shall be performed, in case circumstances occur, having an influence on the level of the mortgage lending value determined prior to contracting a loan agreement.

The consideration of the indicated aspects of conservative appraisal in the detailed bank regulations on real-estate appraisal shall play an important role in the process of their approval by the Commission for Banking Supervision.

Developed by the Specialist Banks Unit of GINB

Approved by:

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