The Valuation of Mortgage Security by Italian Banks

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INTRODUCTION

THIS ARTICLE DESCRIBES A RESEARCH/CONSULTING PROJECT conducted in 2008–09 on the residential mortgage lending process in Italian banks. The focus is on the methods and the procedures implemented by Italian banks in valuing real estate used as collateral for loans both in the loan origination and in the credit monitoring process. The project was carried out under the auspices of the University of Macerata, which has a strong program in banking and real estate finance. Impetus for the study resulted from the disastrous results of the holdings of mortgages and mortgage derivatives in United States banks. The question naturally arose as to whether or not these same risk factors, or others, could be at work in Italian banks, which hold an even greater percentage of their assets in residential mortgage loans—about 24.4 percent in 2008 compared with about 19.1 percent in U.S. banks. Smaller and medium-size Italian banks hold an even greater proportion of their assets (about 30 percent) in these loans.

Sponsors of the study included four banks and four bank foundations (similar to bank holding companies). The four banks have offices in the Marche region of east-central Italy.[1] In return for their cooperation the results of the study, including its recommendations, were made available to the four banks. The authors retained the right to publish articles from the study including processes, findings, and recommendations, without revealing the banks' proprietary information.

BACKGROUND

In order to collect data for the research, the authors developed a detailed questionnaire that was completed by the relevant officers of the banks. Additionally, the authors conducted two sets of interviews with the banks' officers. The questionnaire and interviews concerned the portfolios of mortgage loans of these banks, the procedures used to grant mortgage loans, the methods and techniques used to value the real estate serving as collateral, and the processes used to monitor these loans.

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Unlike the U.S. market experience, write-offs of mortgages in Italy have historically been limited and rarely have resulted in the distress of financial institutions, even in the recent financial crisis. The study included analysis of four principal aspects of the lending and valuation process:

1. The prudential regulation of mortgage lending and real estate valuation imposed by the supervisory authority (i.e., the Bank of Italy) in conformance with the recommendations of Basel II.
2. The valuation documents (appraisals) and procedures used by the banks in valuing the real estate that serves as security for mortgage loans.
3. The methods and procedures used by the panel of Italian banks to screen applications for new mortgage loans.
4. The procedures used in monitoring mortgage loans for continuing credit worthiness.

We believe that the insights we were able to gain in this study could be useful not only to the four cooperating banks but also to other banks and financial institutions in Italy and other countries. The recommendations should be helpful in evaluating an institution's own policies and procedures related to mortgage lending and, ultimately, in avoiding disastrous bank failures.

I. Regulatory Requirements for Mortgage Lending

1. FRAMEWORK AND DEFINITIONS

THIS SECTION DESCRIBES the regulatory requirements for mortgage lending promulgated by the Bank of Italy and emanating from Basel II recommendations. The rules for prudential vigilance apply to the screening process for new loans and the procedures for monitoring existing mortgage exposures. In particular, the rules focus on the operational limits (i.e., the loan-to-value ratio) and the acceptance of mortgages as credit risk mitigation instruments.

As in the U.S., the term *real estate mortgage loan* (*credito fondiario*) refers to a written loan agreement securitized by a mortgage on a real property used as collateral for borrowed funds. Such a loan enjoys privileged tax and regulatory treatments due to the social relevance of property investments. The purpose of the borrowed funds is to buy, build or renew a real property [Bregoli (1999)].[2] In order to be classified as a "real estate mortgage," the promissory note must contain the following provisions:

a. **Maturity:** The loan must have a medium- or long-term maturity (i.e., have an average duration of more than 18 months). With residential mortgages, the amortization term is usually between eight and 30 years.

b. **Mortgage:** A so-called "first grade" or senior mortgage is a pledge of property as collateral for the payment of the debt. Subordinated liens may also be accepted, but the loan-to-value ratio stated for regulatory purposes (see below)—which defines the maximum credit amount—must be calculated considering both the amount of the new loan to be granted and the residual amount of any previous mortgage.

c. **Loan-to-Value Ratio:** As described in detail next, the maximum loan amount is set by the Central Bank as a percentage of the current market value of the real estate pledged as collateral for the loan. Additional securities may lever the loan-to-value ratio under specific circumstances. The reason for this prudential rule is, of course, to limit a lender's expected loss on the credit in case of a borrower's default and subsequent foreclosure on the property serving as security for the loan.

If these provisions are fulfilled, the mortgage loan enjoys—as a medium- to long-term loan—a reduced "substitute" tax of 0.25 percent calculated on the borrowed amount; the "substitute" tax is levied in place of the ordinary, higher indirect taxes related to the cadastral (land) register and mortgage taxes. In addition to other favorable legal standards, mortgages pledging property are not subject to bankruptcy claw-back actions if they have been recorded at least 10 days prior to the bankruptcy declaration of the mortgagor.

Also, a mortgage holder cannot terminate the loan agreement and initiate foreclosure unless the borrower fails seven times, at several points in time, to make interest and principal payments when due under the promissory note.[3] Another protection for a mortgage borrower is that whenever he/she pays off at least one-fifth of the original loan amount, he/she is entitled to receive a proportional reduction of the mortgage or, more precisely, of the interest in the property used as security for the debt.

2. OPERATIONAL LIMITS: THE LOAN-TO-VALUE RATIO

As indicated previously, a main characteristic of real estate mortgages—with respect to other types of loans—is the fixed *loan-to-value ratio,* defined at the regulatory level by the banking supervisory authority, the Bank of Italy. At present, the loan-to-value ratio, calculated as the ratio of the original loan amount to the current market value of the property serving as security for the loan, cannot exceed 80 percent. However, if the debtor delivers additional collateral compliant with the legal standards defined by the same supervisory authority, the loan-to-value ratio may reach 100 percent. Examples of supplementary securities that may be admitted are bank guarantees, insurance policies or payment guarantees of other financial intermediaries [Bank of Italy (2008)].

3. RULES FOR PRUDENTIAL VIGILANCE

The rules governing mortgage lending apply at the international level—more specifically, at the European Union level. The Basel II framework specifies how mortgage securities must be evaluated as credit risk mitigation components affecting the capital adequacy of banks. In principle, the total minimum capital requirements for credit (as well as for market and operational) risk are calculated as a percentage of the risk-weighted assets of a bank. The assessment of risk (i.e., the risk-weight) is provided either by a bank's internal risk rating system or by considering a standard set of factors affecting credit risk (counter-party risk, country risk, duration, etc.). The total capital ratio must be no lower than eight percent. In this respect, real estate mortgages are included in the overall category of collateralized loans, even though prudential vigilance is largely achieved by specifying a mandatory loan-to-value ratio.

The prudential framework considers mortgage security as a credit risk mitigation instrument, as it reduces the risk of loss at default. Although mortgages do not reduce the probability of default of the debtor, they do provide a source of value that can be recovered through foreclosure on the mortgaged property. However, as a general principle, mortgages are only accepted as collateral if the property securing the loan is not "self-referring" to the exposure. This means that the prospects for repayment and recovery on the exposure must not depend primarily on the cash flows generated by the asset itself. The primary source of these cash flows is generally lease or rental payments, or the sale of the property [Basel Committee (2006, 2008)]. Despite this requirement, recognition and eligibility of mortgages as collateral vary based upon the type of the underlying property (basically, commercial versus residential real estate).

The credit risk mitigation capability of mortgages depends further on the methodology for calculating the capital requirements for credit risk adopted by the bank, one alternative being the so-called Standardized Approach, where credit risk is measured in a standardized manner, the other alternative being the Internal Ratings-based Approach (IRB)—split into the foundation or advanced method—which allows banks to use their internal rating systems for measuring credit risk.[4]

Most of the small- and medium-size Italian banks follow a standardized approach while only large banks adopt an IRB methodology, either the foundation or advanced IRB. In our specific case, three of the four banks of the sample follow the standardized approach, while one bank (a member of a larger bank group) has implemented the intermediate method (the foundation IRB). In the following section we therefore focus primarily on the recognition of mortgages as credit collateral in the standardized approach.

a. Rules for screening and loan origination

Prudential regulation in the standardized approach classifies mortgage loans as "claims secured by real estate." This approach includes only the part of the mortgage covered by the collateral that does not exceed the regulatory loan-to-value ratio limitation of 80 percent[5] and provides that the single loan arrangement fulfills the following requirements [Bank of Italy (2008)]:

1. The value of the property must **not** be highly correlated to the credit rating of the borrower.
2. The property must be appraised by an independent professional (appraiser). The appraised value cannot exceed the current market value of the asset, defined as the fair value under which the property could be sold under private contract between a willing seller and an arm's-length buyer at the date of valuation. The appraisal must be clearly and comprehensively documented.
3. The term "independent" refers to the requirement that the appraiser cannot participate either directly or indirectly in the loan origination or monitoring process.

4. The collateral must be disposable within a reasonable time frame. The bank must implement a continuous monitoring process of the value of the collateral.

   The bank must clearly document and address the types of real estate accepted as collateral within the overall lending policy.

5. The property must be adequately insured against damage and deterioration.

Residential real estate. Loans secured by mortgages on residential properties are generally risk-weighted at 35.0 percent (i.e., the asset amount on which the capital absorption rate is determined is calculated by multiplying the loan amount by .35). This percentage is used provided the following requirements are met:

1. The properties must be used or leased by the owner;
2. The prospects for repayment of the mortgage must not depend significantly on the cash flows generated by the same real estate used as security;
3. Although the loan amount cannot exceed 80 percent of the property value, a loan-to-value ratio of 100 percent can be achieved under the condition that additional securities such as bank or insurance guarantees are delivered and provided that the overall exposure complies with the following ratio: **Loan / [market value + additional securities] ≤ .80.**

In the case of properties already pledged by previous mortgages, the loan-to-value ratio must be calculated by adding to the new loan amount the residual exposure of the loans already in place. This requirement accounts for lien priority and for the reduced collateral value of the underlying property.

Commercial real estate. Loans secured by mortgages on commercial properties such as factories, stores, offices, etc., are generally risk-weighted at 50.0 percent (0.5) for the loan amount not exceeding 50 percent of the market value of the property. The residual loan exposure is fully risk-weighted at 100.0 percent. The reduced 50 percent risk rating also requires that reimbursement of the loan does not heavily rely on the cash flows generated by the real estate securing the exposure. The net effect of this requirement is that financing for income-producing real estate is not considered as a real estate mortgage *for risk rating purposes*.

b. Rules for monitoring

The rules for prudential vigilance require a continual monitoring of the loan-to-value ratio of the mortgage portfolio. This rule means that the market value of the properties must be reviewed or reaffirmed periodically. To accomplish this, banks must verify the value of the underlying property at least:

- every three years for residential real estate;
- every year for commercial real estate.

Appraisals may be used to carry out this requirement. However, banks may also implement statistical methodologies (e.g., databanks) to identify real estate values that need to be closely monitored. Should the statistical analysis show a significant decrease in the values of similar properties, the bank must commission a new appraisal. A new appraisal is, in any case, required every three years for loan exposures above three million euros or for those exceeding five percent of the bank's regulatory capital. Financial intermediaries also must check the value of the properties securing the mortgages more frequently (than the one- and three-year requirements) if real estate market conditions change significantly.

II. Valuation Procedures and Techniques

1. GENERAL SITUATION

Our analysis showed that the four banks do not have significant problems with loans in arrears or foreclosure. However, we believe that valuation procedures and techniques present potential difficulties for these, and undoubtedly many other, banks in Italy. Although most appraisals are undertaken by competent experts trained in fields such as architecture, engineering, geometry,[6] and perhaps accounting, these professionals often have limited education and training in valuation procedures and techniques.

The authors noted that in the appraisals provided to them there was little or no justification of crucial numbers such as selling prices, construction costs, incomes, or expenses of other, similar properties. Furthermore, the appraisals of residential properties contain few or no adjustments to the selling prices of comparable properties that have recently sold. The omission of adjustments for changes in market conditions, financing arrangements, location, and

physical differences (such as size, number of rooms, quality of construction, and equipment) renders such appraisals suspect to inaccurate or incomplete value conclusions. While the final value conclusions may be sufficiently operable for lending purposes in a relatively stable market, a downturn in the market of more than 5–10 percent could result in a difficult or, ultimately, an unacceptable level of nonperforming loans.

The consulting report recommended that the banks seek to provide the necessary education and training for employees to be able to supervise properly the efforts of appraisers, and to require appraisers to demonstrate knowledge of appraisal methods and procedures, as well as the technical knowledge of their primary professions (architecture, engineering, geometry, et al.).[7] We recognize, however, that educational programs in the valuation of real estate are in short supply in Italy. Therefore, it may be in the banks' interest, together with other banks and financial intermediaries, to promote the development of educational programs that would be available to anyone wanting to become a professional appraiser.

2. ORGANIZATIONS PROMOTING APPRAISAL STANDARDS AND EDUCATION

Some attempts already are being made to identify and promote the use of accepted appraisal methods and techniques in Italy. NOMISMA[8] and Tecnoborsa have developed a set of valuation standards for some types of commercial and industrial properties, although these standards are incomplete.

TEGoVA, the European Group of Valuers' Associations, attempts to promote the imposition of standards and the development of educational programs throughout Europe. It has published a book, *European Valuation Standards* (402 pages) that contains nine Valuation Standards, 14 Guidelines and eight Appendices. We believe that the acceptance of these standards and their widespread implementation in Italy would greatly benefit the safe and sound lending practices of banks and other financial intermediaries.

TEGoVA has two members in Italy, IsIVI (Istituto Italiano Valutazione Immobiliare) and GEOVAL (Associazione Geometri Valutatori Esperti). IsIVI has some training programs and materials, although they do not seem to be widely accepted and used. GEOVAL has a one-week program of appraisal education and training aimed primarily at geometers.

III. Screening

As noted previously, screening is the process of evaluating the application by an owner, or a buyer, for a mortgage loan. In the evaluation process, the bank needs to weigh three fundamental elements: (1) the likelihood of default by the borrower, (2) the amount of credit at risk; and (3) the potential loss in case of default.

1. PROBABILITY OF DEFAULT

When assessing the probability of default in screening a loan request, especially for the purchase of residential properties, a bank should consider the entire financial situation of the borrower, including the income available to the borrower to make the mortgage payments during the life of the loan, other debts that the borrower may have, and the stability of the borrower's income.

2. AMOUNT OF CREDIT AT RISK

The amount of a loan requested must not exceed the loan-to-value ratio requirement, as noted previously. The loan amount for single-family residential properties is usually well within even a small bank's capacity for granting a mortgage loan, but the exposure to all loans of a particular type should be kept in proportion to the bank's total assets and the percentages of other exposures.

3. POTENTIAL LOSS IN CASE OF DEFAULT

The potential loss resulting from default and foreclosure is a function of the probability of selling the property for at least its market value (as estimated by an appraiser) on the open market. The more general the type of property, the higher is this probability, and vice versa: The more specialized the type of property, the less probable is the probability. Single-family residential properties—the main scope of this study—usually carry a relatively high marketability, i.e., the probability of selling the property for at least its market value.

For residential properties, a bank should rely primarily on the income and assets of the borrower for repayment of the loan—not on the sale or rental of the property. The potential sale of the property in case of default and foreclosure is an important—but secondary—consideration in the screening process. In general, if the income and assets of the borrower are likely not to support the loan, the application should be denied. A bank should also consider whether there is a "margin of error" with the applicant's income and assets in terms of the general economy and the real estate market. If an applicant's income and assets barely meet his or her ability to repay

the loan, any downturn in the local market (emanating from either national or local trends) could endanger the loan. The recent market debacle in the U.S. illustrates the risk undertaken by financial institutions when loans are not evaluated carefully: defaults may occur in large numbers, putting financial institutions and even the general economy in peril.

a. The valuation phase by a qualified professional

Regulations require that a qualified and competent appraiser should perform the appraisal. While in the U.S. basic qualification is indicated by state licensure, and additional qualifications may be provided by professional organizations (such as the Appraisal Institute), there is no specific license law for appraisers in Italy and, as noted above, there is little education and training by professional organizations.

Nevertheless, the competence of appraisers of large, income-producing properties is quite high—equal to that of appraisers in the U.S. This situation results from the use of appraisers who are knowledgeable about financial matters, including the use of valuation techniques such as discounted cash flow (DCF) analysis. Ironically, one of the largest firms in Italy that appraises these types of properties is American Appraisal.

The more serious weakness in the Italian system pertains to the appraisal of one- to four-family residential properties. To correct or ameliorate this situation, we recommend that banks seek to promote the imposition of an appraisal license law and to strengthen the role of professional organizations in the education and training of real estate appraisers, especially residential appraisers.[9] While highly competent in their primary fields, many lack knowledge and competence in appraisal theory, methods and techniques.[10]

b. Evaluation of the job assignment

A bank is charged with assuring that the appraiser is indeed independent. After this basic requirement is met, and the appraiser submits an appraisal, a trained bank employee should review the document carefully to insure that correct procedures have been followed and that all appropriate procedures have been performed. He/she also should check to make sure that the appraiser has signed the appraisal and affirmed his/her independence and absence of conflicts of interest.

c. Validation of the estimated value

A bank is obligated to validate the estimated value in terms of three considerations:

1. Verification of the completeness of the appraisal and the appropriateness of the methods and techniques used. All numbers and calculations should be checked for accuracy, including the physical and legal descriptions of the property.
2. Informal validation of the estimated value from the employee-reviewer's own experience and knowledge of the relevant market. In addition, the reviewer could present in an appropriate form the following elements:
   (a) Location and type of neighborhood;
   (b) Market trends (stable, upward or downward) of the neighborhood;
   (c) Type of properties prevalent in the neighborhood;
   (d) Consistency of the estimated value with the range of values in the neighborhood as experienced by other loans granted by the bank.
3. Formal validation of the estimated value through comparison with other value sources. In Italy there are several databanks that can be used for this purpose. For residential properties the real estate databank "Osservatorio Mercato Immobiliare" (OMI) of the Agenzia del Territorio (Government Land Agency) is very useful. For "core institutional" properties and other large commercial real estate such as offices, stores and industrial properties, other databanks such as those of NOMISMA-IPD or SCENARI IMMOBILIARI combine various sources of market transactions and are very useful.

IV. Monitoring

THE BASEL II AGREEMENTS recommend that central banks develop required processes for monitoring banks' credit portfolios, with the goal of estimating the probability of losses that could occur in the event of insolvencies. Thus, monitoring is required both for loans on real estate and the properties that serve as security for the loans.

As noted previously, large banks can use internally generated estimates to determine their profiles of risk. Medium- and smaller-size banks use the "standard"

method, which requires a periodic monitoring of the values of properties that serve as security for loans. Two methods may be used for this purpose: (1) statistical analysis; and, (2) individual review of loans that present relatively high levels of risk.

As discussed in the section on Screening, databanks can be used (where available) for the statistical analysis in order to assess the current ongoing value, usually in terms of a value range, of the properties. Should the comparison between initial and current market value of the property lead to a significant negative difference, the bank should request a new appraisal in order to assess the current effective loan-to-value ratio and to monitor negative trends.

With respect to the second method of examining individual properties, banks may need to hire appraisers to review the original appraisals and determine whether, or to what degree, they are still applicable. This determination should include documentation on at least the following issues:

1. Has the relevant local market undergone significant changes in the last three years? In the case of either a positive or negative response, what are the elements in support of the analyst's contention? Are value changes consistent with changes in the rate of inflation? These conclusions should be documented.
2. Have the construction and physical characteristics of the buildings been modified during the last three years? In case of an affirmative response, in what ways have the buildings changed? Has the condition of the buildings improved or deteriorated? What modifications were made to the buildings?
3. Has the surrounding neighborhood and the urban area in general changed in the last three years? If yes, in what ways?
4. Is the value of the property estimated as at least equal to the value estimated by the first appraisal? The response should be explained and documented.

ADDITIONAL ELEMENTS RELATIVE TO COMMERCIAL PROPERTIES (CAPABLE OF PRODUCING INCOME)

1. Is the property capable of producing net income at least equal to the amount previously estimated? The response should be documented.
2. In the case of rental apartments, what are the occupancy and vacancy rates? Are they above or below the rates at the time the loan was made?
3. Is the property in good condition? Have repairs been made when needed, and is maintenance up to standards?
4. Has there been a turnover in tenants (commercial or residential), and how has turnover affected the property's net income?
5. For manufacturing or storage facilities, have the tenants changed? How and what effect do these changes have on the property's net income?
6. Is the property still well-located and well-designed for the purpose it was intended? Why or why not?

Based on the study of these Italian banks, the recommendations of Basel II, and the rules promulgated by the Bank of Italy, we recommended that each bank develop a schedule of properties in an appropriate spreadsheet or database program, with the appropriate time frames for monitoring. For banks not currently monitoring properties in this way, a major organizational effort will be required, with staff to implement and oversee the process. Specialists in residential, commercial, industrial, and office properties will be required. We also concluded that that the monitoring function of the banks should be completely separate from the lending department and staff.

SUMMARY AND CONCLUSIONS

This sample of banks does not have significant problems with mortgage defaults and foreclosures. Losses from nonperforming and underperforming mortgage loans are minimal, particularly in the residential sector. These banks, and in general Italian banks, did not engage in either the direct lending of subprime loans or the financing of other nonbank intermediaries. Furthermore, the downturn in the Italian economy did not result from a collapse of the residential real estate market, as occurred in the U.S., but rather from the collapse of financial institutions in the U.S. and the subsequent worldwide recession. Home values in Italy, in general, did not decline nearly as much as they did in the U.S.

The relatively small losses on residential mortgage loans probably can be attributed largely to the relative strict regulation of banks and other financial intermediaries and, more specifically, to the imposition of a specific loan-to-value ratio. In this respect, the proper assessment of the value of the securitizing property is a key element that contributes to the mitigation of the potential loss on

the loan that could occur in the case of default. Moreover, lending institutions are required to assess the quantity and quality of a borrower's income. Stability of income is a major factor considered in the lending process, as is the loan-to-value ratio. Banks are careful to evaluate the property, the neighborhood and the general economy of the surrounding area.

Careful analysis of both the probability of default and the value of the underlying securitizing property as a credit risk mitigation instrument has served Italian banks well. However, our analysis shows that, in general, the value estimates made by Italian appraisers are only weakly justified in terms of the:

- methods and techniques used in relation to the type of property appraised (residential, commercial, industrial or in construction);
- data used in terms of comparable properties and adjustments made to the prices paid for such properties.

Although we did not attempt to evaluate the actual values estimated, it stands to reason that the likelihood of value estimates not accurately reflecting the market and market expectations is undoubtedly greater if faulty means are used to obtain them. We believe that implementation of stricter appraisal standards will help improve the safety and the profitability of the sample banks, and that these same observations and recommendations undoubtedly apply to other banks—both domestic and foreign. ■

ENDNOTES

1. The financial institutions are: Bank of the Marche, the People's Bank of Ancona, the Cooperative Bank of Corinaldo, and the Savings Bank of Fabriano and Cupramontana. Bank of the Marche is part of a large bank group, the Saving Bank of Fabriano and Cupramontana and the People's Bank of Ancona are medium-size banks, and the Cooperative Bank of Corinaldo is a small bank.
2. The question of whether or not the loan amount must be dedicated to real estate investments is still controversial both at the theoretical and the jurisprudential levels. Contrary to most of the doctrine, in 2004 the Italian Supreme Court stated that the borrowed funds are not tied to a specific property [Constitutional Court, No. 175/2004].
3. Payments are overdue if made between 30 and 180 days after the contractual term [Bank Law No. 385/1993, Art. 38].
4. For a detailed overview and analysis of the Basel II framework please refer to Basel Committee on Banking Supervision, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version*, Bank for International Settlements, June 2006, and related amendments.
5. The loan amount exceeding the regulatory loan-to-value ratio cannot be classified as "claims secured by real estate."
6. In Italy geometry is a well-known and highly regarded profession. It is composed of persons who are highly trained in the measuring and cost estimation of buildings.
7. The consulting report submitted to the banks contained a section on appraisal methods and techniques for both one- to four-family residential appraisal and income property appraisal.
8. The letters NOMISMA do not stand for words. Rather, the name of this research organization is taken from the ancient Greek word *nomisma*, which means the real value of things.
9. Licensure is required for real estate agents.
10. An argument sometimes advanced by those opposed to licensure of appraisers is that the U.S., which has relatively strict appraisal licensure requirements, has not avoided severe market downturns. Appraisals without strict lending regulations have been ineffective in preventing market collapses, while in Italy the opposite has been true.