

# Implementing Risk/Property Ratings into Appraisal Reports

**July 20, 2010 – Washington D.C.  
11:00AM – 12:30PM**

# **Implementing Risk/Property Ratings into Appraisal Reports**

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# **Real Estate Market Advisory Group (REM)**

- **Part of the UNECE**
- **REM's Goal – Contribute to a clear and transparent risk assessment of real estate properties used as collateral of financial products**
- **Members of REM are from Italy, China – Hong Kong, UK, Canada, USA, and Austria**

# Current Methods of Dealing with Real Estate Risk in Lending

- Credit Risk of the Obligators
- Valuation of the Real Estate
- Loan-to-Value (LTV) Ratios
- Interest Cover Assessed at Loan Origination (e.g. DSCRs)
- **No Risk Analysis of Underlying Asset!**

# What is Needed for a Risk Profile of Real Estate Assets

- **Cyclicality inherent in property markets**
- **Relative liquidity of property**
- **Objective assessment of relative medium term marketability/liquidity**
- **Prospective volatility in market value compared to other securities**

# Congruent Goals of a Property & Risk Rating System

- **Compliment and Enhance Existing Risk Rating Systems \***
- **Provide a Robust Risk Management Tool for Secured Lending**
- **\* - Goal is to integrate with the internal risk rating systems (IRRS) under Pillar 1 of the Basel II Accord.**

## ■ Don's Turn ☺

- **What goes into loan risk ratings right now, what they mean, general discussion, how might property risk ratings get integrated with loan risk ratings as requested by the Basel II Accord, et al**
- **((Risk Rating Models Table is next slide))**

# Risk Rating Models

Aaa to AA3	A1 to A3	Baa1 to Baa2	Baa3 to Ba1	Ba2 to Ba3`	B1	B2	B3 to Caa			Moody's
AAA to AA	A+ to A-	BBB+ to BBB	BBB- to BB+	BB to BB-	B+	B	B- to C			S & P
excellent	very good	good	above average	average	below average	poor/ special mention	very poor/ substandard	doubtful	loss	Internal Bank Ratings
1	2	3	4	5	6	7	8	9	10	PaM
excellent	very good	good	slightly above average	average	slightly below average	mediocre	poor	very poor	disastrous	PaM

# PUBLICATIONS

- **October 2003 TEGoVA – “European Property and Market Rating: A Valuer’s Guide”**
- **September 2006 VOB, Bundesverband Öffentlicher Banken Deutschlands – Germany – very similar to TEGoVA’s publication**
- **January 2007 RICS – “Property Risk Scoring: The reporting of investment risk to clients”**

# USERS

- **Germany, Austria and Switzerland Banks – proprietary and confidential**
- **Itrium – TEGoVA approved software company**

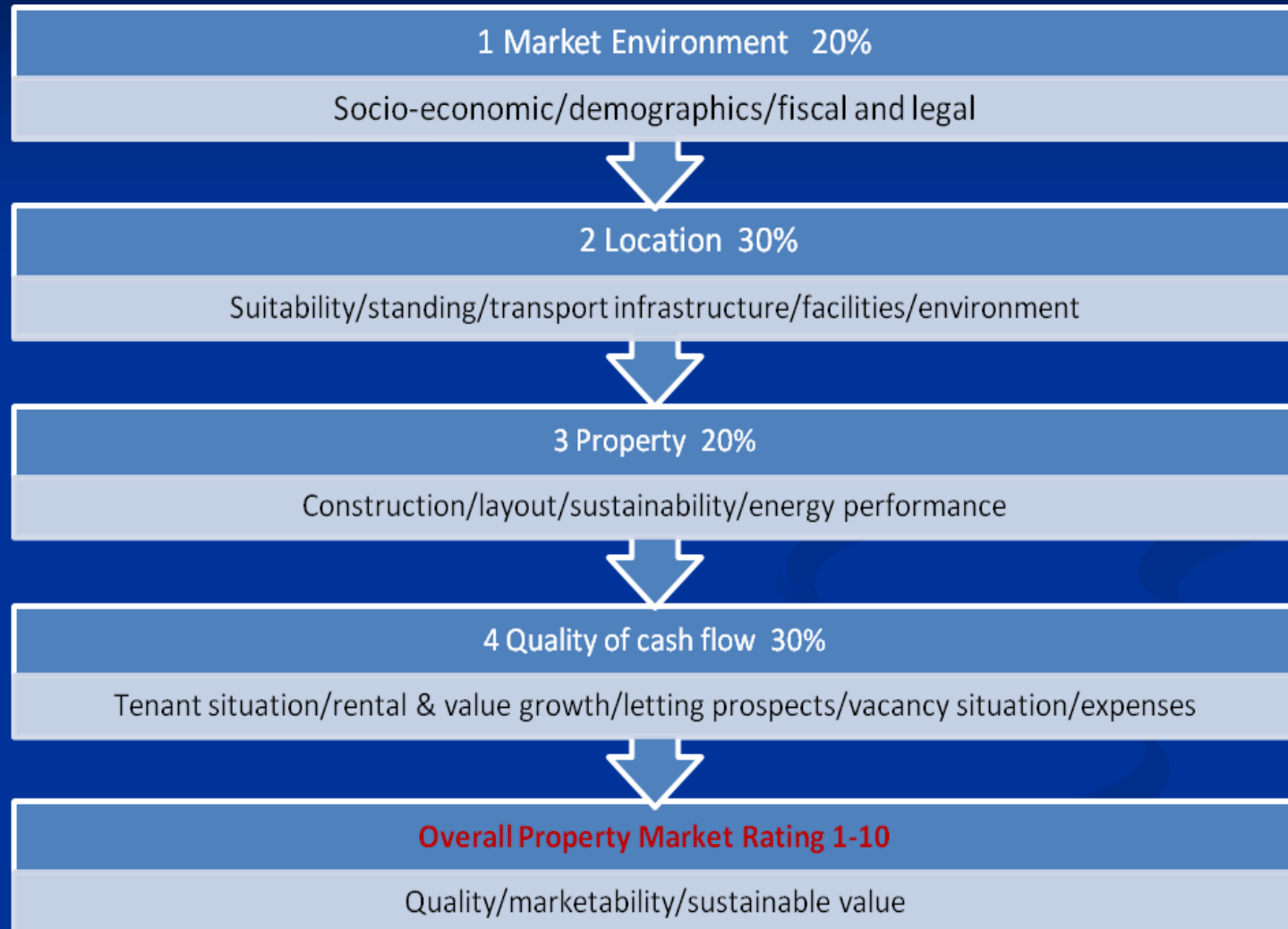
**OK – So How Do We  
Do This?**

# 4 Principal Elements

- 1. Socio-Economic Environment**
- 2. Location**
- 3. Property; and**
- 4. Cash Flow**

**Each of the 4 principal elements is sub-divided into a number of subsidiary elements**

# PaM Property & Market Rating System



**Let's go to the TEGoVA  
publication and see the  
detailed weightings and a  
sample property rating**

**(George – Return to Slide 15 ☺ )**

**WARNING: The next few  
slides are written in English,  
not American 😊**

**Please ignore the archaic spelling and grammar 😊**

# Consistent Results

- Training programmes (face to face and web based)
- Certification on successful completion
- Help files on the web based or installed system
- Imbedded constantly up-dated socio-economic data
- Fixed weightings of sub and main criteria ensuring that manipulation of the results is difficult
- Facility to mine down to individual data used in assessments of criteria to check reasoning, including comment fields and audit results
- Rating only completed following senior third party authorisation.

# Practical Applications

**1. At origination of loans, setting lending policy, pricing, audit and automating grant or refusal of loans**

# Practical Applications

- 2. During portfolio management and ongoing risk assessment implementing, inter alia:**
  - A. multi level cluster analysis to establish risk homogenous assets**
  - B. assess risk concentrations, warning systems, etc**

# Practical Applications

- C. Enable programmes to facilitate long term reduction in probability of default (PD), reduction loss given default (LGD) and exposure at default (EAD)**
- D. Facilitate Mass appraisal systems**

# Practical Applications

- 3. Meeting reporting requirements process under Basel II standard , foundation and advanced internal risk based (IRB)approach**
- 4. At securitisation or covered bond issuance to ensure efficient pricing**

# Applied to Lending

Asset	PaM	Credit score	Risk Weighted Average	LTV	Interest Cover	Profit margin over EURIBOR Basis points
Poor	8	7	7.4	60%	1.75	225
Medium	5	5	5	70%	1.5	150
Good	3	2	2.4	80%	1.25	100

# Discussion Time

- **Issues**
- **Concerns**
- **Benefits**
- **Thoughts**
- **Etc.**
- **% Weightings**
- **Bulgaria vs. USA**
- **Detroit vs. Charlotte**
- **Owner Influence**
- **Consistency**
- **.....**

**Wrap Up!**

**Thank you for your participation!**