# RegCORE Client Alert

**ECB-SSM provides an update on its "Commercial Real Estate on-site inspection campaign" (the CRE Campaign) and communicates best practices on CRE risk management**

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# ECB-SSM Investigations

ECB-SSM provides an update on its "Commercial Real Estate on-site inspection campaign" (the **CRE Campaign**) and communicates best practices for CRE risk management


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## QuickTake

During December 2021, the European Central Bank (**ECB**), acting in its role at the head of the Banking Union's Single Supervisory Mechanism (**SSM)**, published its plan[1] to strengthen its supervisory focus on credit institutions' exposures to what it judged to be "vulnerable sectors". This includes those sectors of economic activity that have been hardest hit by the COVID-19 pandemic and this extends to the commercial real estate (**CRE**) sector specifically as well as a number of others, such as the aviation finance sector.

Despite attracting considerable investment during the prolonged low interest rate environment in the euro area, the CRE sector has seen a large decline in transaction numbers and prices. Rising interest rates coupled with lower returns means the ECB-SSM has concluded that vulnerabilities could build up on collateral valuations and lending standards, including an adverse outlook for legacy non-performing loans and exposures (**NPL**s) as well as the addition of new stocks of NPLs with weaker prospects.[2]

The ECB-SSM announced that it would during the course of 2022 through to 2024:

- regularly monitor Banking Union supervised institutions' (**BUSI**s) exposures to vulnerable sectors; and
- conduct targeted review and on-site inspections (**OSI**s) of BUSIs exposures to CRE.

On 17 August 2022, during the midst of the European summer recess, the ECB-SSM published an unusually detailed article ("Commercial Real Estate: connecting the dots") in its August edition of its Supervision

[1] As part of its publication of the ECB-SSM's Supervisory Priorities and Risk Assessment for 2022-2024 (available here), which readers may also want to review in conjunction with "Navigating 2022", as available from PwC Legal's EU RegCORE.

[2] It should be noted that in the same August Supervision Newsletter, an article "Are banks prepared for interest rate and credit spread shocks?" was published detailing areas under a "horizontal targeted review" across six modules at 31 BUSI groups under closer scrutiny following completion of the first phase in May 2022. This targeted review will be completed by the end of 2022 and factor into the 2023 Supervisory Review and Evaluation Process (**SREP**) as well as into future OSIs and off-site supervisory activities as well as setting of ECB-SSM supervisory expectations more generally.

Newsletter updating on its findings in the CRE focused OSI (which it refers to as the **CRE Campaign**) that was commenced in 2018 as well as a CRE targeted review, which was launched in 2021.

The CRE Campaign and CRE targeted review aim to span all areas of credit risk management and the findings communicated by the ECB-SSM so far are not favourable. They therefore point to further ECB-SSM supervisory inspections of BUSIs in respect of their other business activities, a risk of the ECB-SSM issuing a number of unfavourable SREP letters to BUSIs[3] as well as the risk of a lot of remediation work ahead for those active in the CRE sector but also improvements that will need tackling in BUSIs' lending and structured finance activities more generally. The findings also indicate a risk of further supervisory inspections being led by other EU supervisory authorities covering activity taking place outside the Banking Union Member States as well as possibly further afield.

This Client Alert assesses the key takeaways and findings from this ECB-SSM article as well as providing a summary of the "Best Practices for CRE Risk Management" discussed in the article. Both of these supervisory messages set a clear tone on supervisory expectations ahead of the ECB-SSM possibly issuing more formal supervisory guidance (notably on collateral valuations and appraisers) as well as targeted communications to individual BUSIs – including in unfavourable SREP letters. This Client Alert should also be read in conjunction with our coverage on the ECB-SSM's 2018 Supervisory Guide to OSIs and IMIs (the **OSIIMI Guide**).[4]

## The ECB-SSM's findings on CRE risk management – the story so far

The ECB-SSM's supervisory efforts on CRE risk management have a differing focus, even if they are conceptually intertwined. Notably:

- the CRE Campaign is an OSI conducted at approximately 40 BUSI groups under review. It covers all CRE portfolios and all areas of credit risk management, in particular collateral valuation and all related processes; and

- the CRE targeted review is a wider-reaching thematic review focusing on 32 credit institutions and "zooming in on a smaller sample" in a subsequent phase. The CRE targeted review focuses on their credit risk management of emerging risks in domestic CRE portfolios (notably office and retail exposures), using peer benchmarking as a basis for assessing critical elements of risk management.

The ECB-SSM approached its CRE Campaign by setting a common term of scope for its OSI as well as agreeing on common work programmes for the BUSI groups under review. This allows for the results to be highly comparable for the ECB-SSM and thus map risks and findings (summarised below) across the CRE sector. Furthermore, by using the article as a first form for such efforts, to communicate what it considers to be "good practices" (equally as summarised below) the ECB-SSM is setting a clear message in this area. Moreover, such comparability also permits the ECB-SSM to consider and then direct further supervisory efforts in respect of credit origination in areas other than CRE more generally.[5]

The CRE Campaign's scope was set sufficiently wide so as to cover a large set of processes, market segments, geographies, portfolios and types of financing. In its article, the ECB-SSM stated that:

> "So far, segments like hospitality, retail, office and logistics have been assessed, looking at all types of financing. The main geographies covered are continental Europe, the United Kingdom and North America. The portfolios analysed are the lending book and foreclosed assets."

Collateral and CRE asset valuations are under specifically close scrutiny. The CRE Campaign looks to assess how documented risk management policies and procedures were and are actually put into practice. If practice does not reflect what has been documented, then valuations can be skewed and decisions based thereupon may not be fully reflective of relevant risks.

A key area of focus concentrates on the robustness of procedures and accuracy of actual collateral valuations. Correct collateral valuations are crucial as they drive a wealth of other key risk assessment metrics, ranging from loan-to-value (LTV) ratios when originating and monitoring loans along with loss given

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[3] See coverage on for example the 2021 SREP findings available from PwC Legal's EU RegCORE, available here.
[4] The OSIIMI Guide is available here. Coverage from PwC Legal's EU RegCORE on that development is available here.
[5] Readers may also wish to take note that the European Systemic Risk Board (**ESRB**) during August 2022 published Working Paper (No. 136) "Interbank credit exposures and financial stability" Working Paper (No. 137) "Macroprudential policy and the role of institutional investors in housing markets" which, while not being official policy stances of the ESRB nor having any binding effect, nevertheless demonstrate some of the areas that ESRB staff are working on in the context of the ESRB's mandate for macroprudential oversight of the EU's financial system (and not "just" the Banking Union).

default (**LGD**) for internal ratings-based (**IRB**) approaches and IFRS 9 models as well as for calculating provisioning more generally.

As part of the CRE Campaign, the ECB-SSM employed, in addition to a dedicated central project management office, a total of 150 CRE inspectors and certified CRE appraisers in the inspection teams and used a dedicated tool to challenge collateral valuations. The ECB-SSM article also states that in terms of its examination techniques employed[6] "[…] it combines the review of policies and procedures with the analysis of selected credit files and appraisal reports."

**The ECB-SSM's findings – more needs doing and well beyond CRE**

The ECB-SSM's article gets straight to the point:

> "For most of the banks reviewed, the CRE Campaign has raised concerns regarding lending standards, collateral valuation and monitoring processes. Worryingly, a lot of these issues are cross-cutting, extending beyond CRE."

In light of the above, BUSIs may want to review their risk management policies, procedures and how these are put into practice outside of the CRE sector - both in respect of regulated activity conducted in the Banking Union as well as operations outside of the Banking Union across the EU but equally further afield. The same also applies to non-Banking Union headquartered financial services firms active in the CRE space and other segments as other non-Banking Union and even non-EU financial services supervisory authorities may decide to conduct similar on-site inspections and targeted reviews.

***Findings from the CRE Campaign***

In summary the ECB-SSM's findings from the CRE Campaign concluded the following issues for CRE risk management practices:

1. ***Loan origination: today's new loans could be tomorrow's problem i.e., NPLs***

   The CRE Campaign focused primarily on review the credit origination process (a longstanding focus of the SSM since its start in 2014 as well as work on NPLs more widely). The ECB-SSM however found that:

   > "[…] several banks have no underwriting criteria and pay insufficient attention to cash flows, also in bad times. This suggests that banks have not yet fully integrated the lessons drawn from the global financial crisis: in particular, banks can incur significant losses on collateralised lending, when values fall sharply and defaults increase steeply due to a substantial amount of debtors quickly running into financial distress. Banks should therefore scrutinise expected cash flows both in good and bad market conditions."

   Moreover, the ECB-SSM found that for development projects several reviewed BUSIs lacked adequate processes to ensure sponsors are directly invested in the projects and have "skin in the game", notably in a downturn. The ECB-SSM also concluded that "quite a few" BUSIs have a high share of loans that have large balances falling due at maturity (i.e., bullet or balloon loans) and that these failed to apply a debt yield ratio.[7] Unsurprisingly the ECB-SSM, concluded that gaps in credit origination policies meant that reviewed BUSIs failed to account for climate and environmental risks in their CRE exposures.[8]

2. ***Weaknesses extend to the monitoring of loans***

   Inspectors also found that the weaknesses in the origination process were also present in the monitoring process, which can exacerbate the origination and risk control processes identified above. A key area of concern is lack of monitoring of tenant risk (as a key cashflow generating item CRE lending) and the tenants' cashflow generating capacity. This is an area that was tested heavily during the COVID-19

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[6] As contemplated under the OSIIMI Guide is available here. Our Client Alert on that development and a discussion on such techniques is available here.

[7] The debt yield ratio is independent from financial market conditions, as it simply uses the net operating income of the property and the loan amount. It is thus unaffected by fluctuations in interest rates or property values and can help banks compare risks, in addition to more commonly used financial metrics such as the debt service coverage ratio.

[8] Such criticism had already been addressed by the ECB-SSM to credit origination and absence of climate and environmental considerations assessment report on that topic published 14 March 2022. See coverage from PwC Legal's EU RegCore available here.

pandemic and lockdowns. Equally, the ability and willingness of CRE project sponsors to inject more equity is an area that BUSIs are expected to better monitor and identify such risks derived from this.

On a wider note, the ECB-SSM inspectors concluded that several BUSIs:

- lack, or have an inadequate level of key CRE-related metrics in their early-warning framework and flagging of exposures on watchlists;[9]
- would also benefit from dedicated tools to better identify CRE projects requiring higher scrutiny due to cost overruns, delays in selling the assets or shrinking developer margins;
- do not have commonly defined basic CRE risk metrics at the portfolio level in particular concerning:
  - the loan-to-value ratio;
  - loans' refinancing risk exposure (which the ECB-SSM (correctly) notes is particularly relevant for bullet loans and loans with high balloons);
  - the location of the assets financed (prime versus non-prime);[10]
- have in general not sufficiently performed sensitivity analyses on CRE exposures, especially to measure the potential impact rising interest rates;
- have not considered off-balance sheet items in their analyses, even though these items represent a large part of CRE exposures; and
- employ scenarios developed in the sensitivity analyses that are in general too soft.

3. ***Prudential and accounting practice underestimate risks***

Inspectors concluded that those BUSIs with a high share of granular domestic exposures also have the highest gaps in provisioning due to misclassifying CRE exposures in risk buckets. Equally, several of those BUSIs hold significant legacy NPL portfolios. These BUSIs were found to also have too much room for interpretation in their NPL criteria generally and forbearance practices specifically and consequently do not adequately (or at all) consider CRE-specific risks. Inspectors also found that many BUSIs had a deficient framework for identifying speculative exposures which are subject to higher risk-weighted capital requirements. On specialised lending portfolios, inspectors conclude that some BUSIs underestimated how these are to be treated and applied internal ratings-based models in a "non-conservative manner" or failed to develop dedicated models despite these being required. On IFRS 9 standards, shortcomings in setting triggers to mark a significant increase in credit risk, such as the use of the quantile approach were identified.

4. ***Collateral valuation – a key activity that lacks safeguards***

Inspectors were quite correct that "Despite its importance, collateral valuation is a blind spot for many of the banks reviewed." Basic shortcomings, such as failing to update appraisal reports (as required under the CRR) at least every three years or to perform ad-hoc re-evaluations when market conditions change were identified at several BUSIs. The selection of appropriate appraisers[11] as well as quality review framework for valuers[12] along with weaknesses in content of appraisal reports[13] were signalled out by inspectors as bad practice and thus drivers of risk, in particular where key information or calculation parameters are not provided to the BUSI.

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[9] The article reminds the reader that "in particular a high loan-to-value (LTV) ratio, a low debt service coverage ratio or a decrease in the collateral market value can be early signals of increased risk."

[10] The article noted that: "Prime locations are typically centrally located, well connected and of good quality, e.g., a property in a large city or an office in a central business district. In the context of the current crisis, where CRE markets are becoming ever more polarised, asset location is a key factor in identifying vulnerabilities and assessing the overall robustness of CRE portfolios."

[11] The article reminds readers that "Appraisers must be independent and submit unbiased valuations, however, some banks accept valuations mandated by clients, even without a reliance letter. They can also call on the same appraiser several times in a row to value a given asset, in the absence of a framework for ensuring any rotation of appraisers. In the same vein, the remuneration of appraisers was in some instances problematic as it did not ensure their independence. Either it was too low to enable them to double-check key data provided by banks or it was too dependent on the collateral's market value. The higher the market value obtained, the higher the appraiser's fee. Where banks employed internal appraisers, they were sometimes revealed to be part of the first line of defence or were lacking the required certification."

[12] Specifically, the ECB-SSM concluded that "Several banks have not set up a quality review framework for valuers. They do not scrutinise key parameters such as the vacancy status of the property, the capitalisation rate of the project (estimating the return an investor could make on a property), the contractual rents or the maintenance cost of the building, the discount rate or the methodology used (comparable transactions, the discounted cash flow approach, etc.). It is important to stress that even if the appraisal reports come from valuers with recognised international or national certifications (e.g. RICS, Hypzert, ECO), banks are still responsible for setting the collateral valuation."

[13] Particularly the ECB-SSM found that key information ranging from rental contracts through to validity checks on building permits or the status of the building was missing. Thus, valuers have to make their own assumptions which may reflect actual conditions. Furthermore, for many asset valuations reviewed, the valuation approach and the calibration of parameter values were not adequate, also leading to significant asset value overstatement.

***Findings from the CRE targeted review***

In summary the ECB-SSM's findings from the CRE targeted review assessed the following items as "emerging risks and challenges to that sector" (as well as applying beyond "just" CRE). While BUSIs generally had credit origination policies and procedures as well as risk appetite frameworks covering such risks, many did not have risk limits with the required level of detail or sufficient capture of realistic assumptions for the size and complexity of their portfolios nor means to track deviation from underwriting criteria.

a. ***Rising construction costs***

Unsurprisingly rising material costs (due to supply chain stresses as well as inflation) increase future construction projects, thus affecting future supply. However, it also impacts basic expenses for upkeep of buildings i.e., capex costs inasmuch as costs for retrofitting older buildings;

b. ***Normalisation (i.e., rising) interest rates***

Rising interest rates following a prolonged period of low rates is impacting credit risk. Variable rates loans are at risk of causing issues for borrowers' repayment capacity. The material volume of CRE bullet or balloon loans pose refinancing risks for borrowers when their loans mature. Given the above-mentioned weaknesses and an absence of a well calibrated credit risk cycle, the affordability of some borrowers may not be as robust as creditors had originally assumed. This is also the case as some BUSIs did not have automated covenant monitoring tools embedded into processes (covenant monitoring alerts for debtors show signs of distress). In addition, several BUSIs did not sufficiently capture the forward-looking perspective of borrowers' financial position when assessing forbearance and unlikely to pay (UTP).

c. ***Structural transformation i.e., bifurcation of the CRE market in particular during the COVID-19 pandemic***

While the ECB-SSM notes that prime properties have fared well, non-prime assets have become less attractive for investors. Increasingly, landlords of non-prime assets have had to offer tenants greater flexibility in order to retain them and this puts pressure on landlords' ability to recover their costs through rent increases.

d. ***Climate transition risk***

As with the findings above the ECB-SSM concluded that BUSIs need to identify, understand, mitigate, measure and manage the range of transition and physical climate risk that they could be exposed to. This includes improving efforts to collect accurate climate data and energy performance certificate (EPC) ratings for buildings that are financed. While the ECB-SSM acknowledged that there are structural challenges preventing the collection of all data, certain BUSIs were not doing everything they could to collect data, within those structural constraints. Further information on BUSIs' climate risk management practices will become available later in 2022, when the ECB-SSM will publish its findings from the thematic review on climate-related and environmental risks.

## The ECB-SSM's good practices for CRE risk management

The ECB-SSM's findings summarised above inform what it has set out as good practices for CRE risk management in the following components of the credit risk cycle (summarised below):

I. Credit origination component;

II. Monitoring and classification component – including:
   1. Early Warning System (**EWS**);
   2. Significant Increase in Credit Risk (**SICR**) of purposes of IFRS 9;
   3. Forbearance and thus forborne exposures – which is already headed to the Collections component;
   4. Unlikely to Pay (**UTP**) – which is already in the Collections component;
   5. NPL – which is already in the Collections component;

III. Collections component; and

IV. Risk Appetite component.

***Phase 1 of the credit risk cycle: good practices for risk appetite and risk limits***

The ECB-SSM reminds BUSIs that they should have:

- a clear risk appetite framework including processes, limits, and controls which define how much risk they are willing to assume, taking into account the type of exposures, the market segment, the geographies and key risks such as collateral type; and

- for collateral, good practice at several BUSIs developed internal scoring methodologies for consistent risk assessment of each property, taking characteristics such as location, building quality and climate risk aspects into consideration. These BUSIs then limit the volume of the loans they can grant to weak property scores, or only grant loans against these properties if there is an agreed plan to improve the building. This approach was considered a good practice as it takes a more proactive, portfolio approach to limit risk and limits exposure to the negative effects of a transformation in the market (outlined above) and climate transition risk.

***Phase 2 of the credit risk cycle: good practices for loan origination***

The ECB-SSM reminds BUSIs that they should:

- have detailed and clear underwriting criteria, including a wide range of risk metrics which are assessed in each loan application. Any deviation from these criteria should be reported so that BUSIs can ensure that they are operating within their own risk appetite in the risk appetite framework;
- adopt the positive evaluated measures evidenced by certain BUSIs that ensured that their risk metrics did not solely rely on the value of collateral with the loan-to-value (LTV) ratio, but rather target the cash flows and repayment capacity of the property or borrower. Some demonstrated that they consistently used debt coverage service ratio, interest coverage ratio, and debt yield in each application, with the latter being especially important for "bullet" or "balloon" loans. Additional metrics were included for development projects, such as the loan-to-cost ratio, the expected developer's margin as well as the amount of equity to be injected, and proportion of units to be pre-sold or pre-let before a loan is disbursed;
- means to measure the developer's credibility also needs to be verified;
- minimum hurdles in place for each metric, which if not met require mitigating measures prior to granting a loan. Equally tighter hurdle rates should be applied for riskier types of lending. Where deviations from policy are granted, both the deviations and mitigating measures should be recorded and an overall cap was placed on the total amount of permitted deviations. The ECB-SSM evaluates this as ensuring that approved loans are largely granted within the established policy requirements;
- should carry out sensitivity analyses to ensure loans can withstand a certain amount of stress. The scenarios used for this analysis should be tailored to the specific risk of the loan, such as whether it is "non-recourse", has a variable interest rate or will have a large instalment due at maturity (leading to refinancing risk). The ECB-SSM warns that rising interest rates and inflationary pressure means that sensitivity analysis is more important than ever for ensuring banks identify vulnerabilities and include mitigants before granting a loan;
- ensure assumptions are kept up to date with market expectations and included a level of conservatism for the forward-looking assumptions; and
- when assessing refinancing risk at maturity, BUSIs should ensure that the final instalment amount is likely to be repaid in full, and also carry out a scenario analysis.[14]

***Phase 3 of the credit risk cycle: good practices for monitoring and classification***

Each of the EWS, SICR, forbearance and UTP components and respective metrics cover different concepts and different levels of risk in credit risk management. The ECB-SSM considers that good practice involves having detailed methodology and data that feed into each of these risk metrics and hurdles in place to ensure that certain standards are achieved. Once a loan is granted the ECB-SSM expects that each component of the credit risk cycle should have a coherent set of thresholds for each of the elements to capture incremental increases in risk. This has a primary aim of ensuring that when a borrower's financial position is deteriorating, they will move coherently and consistently through the cycle.

[14] The ECB-SSM stated that a positive example from its efforts found that some BUSIs compare the number of years it would take the loan to be repaid based on the current cash flows with the remaining time the asset can be used. This is to ensure that if a loan cannot be refinanced by a third party, the bank is still confident of repayment through the cash flows from the asset within a reasonable timeframe. This is good practice for all "bullet" and "balloon" loans.

The ECB-SSM noted that good practice, observed at the "most advanced banks"[15] meant these:

> "[…] have sophisticated IT systems which capture financial information, covenants, and allow for efficient processes which have policies embedded within the systems. The objective is to allow analysts to focus on assessing credit risk rather than being overly burdened with inefficient processes and complex policies. It also facilitates a consistent approach to assessing risk which can be more easily verified by the second and third lines of defence. This does not mean that assessments should be fully automated. Commercial real estate loans can be quite complex; therefore, a case-by-case and in-depth qualitative assessment is still required, in particular for forbearance and UTP classification. Ultimately, having an efficient framework and tools which support this assessment would allow banks to manage any emerging risks more proactively which may ultimately limit loss."

**The CRE campaign identified additional good practices around exposure classifications, notably:**

- ***Forbearance and the concept of financial difficulties*** - in the event of delays in construction and/or commercialisation, extension of maturities in the context of CRE finance development appears to be quite common. In this regard, "advanced banks" define circumstances under which an extension of the loan or other modifications can (or could) be considered as a forbearance measure when the debtor is in financial difficulties, e.g., due to unplanned delays in completing the project and/or obtaining the permits needed or due to a significant decrease in the developer's margin;
- ***Forbearance and affordability assessments*** – must define specific criteria on how to perform affordability assessments in the context of CRE financing. The ECB-SSM states that the criteria should take into account the location and condition of the asset, the comparison between the cash flows generated by the asset and the capex needed to maintain its value, and a sensitivity analysis to measure the impact of an increase in interest and/or construction costs. Affordability assessments should be documented. They should be carried out not only when a forbearance measure is granted, but also after the one-year cure period to dispel any concerns regarding the borrower's ability to comply with post-forbearance measures;
- ***IFRS 9 backstop triggers*** – when the probability of a default is dependent on collateral values, especially in the context of non-recourse bullet loans, the IFRS 9 backstop triggers used should include significant changes in the value of the asset given as collateral;
- ***UTP assessments*** – a comprehensive set of UTP triggers should be employed based on credit events likely to occur or events specific to the CRE sector, which should go beyond default scenarios. In this regard, the set of triggers at group and entity levels should include for example the loss of major customers/tenants or contractors, lacking refinancing options, continued equity injections from third parties or repeated loan restructuring or, more broadly, justified concerns about the borrower's future ability to generate stable and sufficient cash flows. UTP assessments should be documented. They should be carried out as soon as a UTP trigger is hit, irrespective of the existence of arrears; and
- ***Regulatory classification of speculative lending*** – requires a place a proper identification framework for speculative immovable property financing to be maintained, as this is a riskier category of CRE. The ECB-SSM considers that good practice is to extend this to all processes, beyond capital adequacy, such as origination, monitoring, risk classification and IFRS 9 models. Ongoing checks should be performed by the first and second lines in a three lines of defence risk and compliance model.

***Spanning all phases of the credit risk cycle: good practices for collateral valuation***

The EBA Guidelines on loan origination and monitoring (the **EBA Loan GL**)[16], which the ECB-SSM noted have recently come into force, represent a major step forward in strengthening collateral valuation frameworks. They include a dedicated chapter on collateral valuation, specifying expectations regarding valuation at granting, monitoring and revaluation or the selection of appraisers. The following bullet points summarise best practices identified in the CRE Campaign benchmarking compliance with the EBA Guidelines.

- ***Rotation and independence of appraisers*** – to have an effective rotation of appraisers, a newly appointed appraiser should, according to the ECB-SSM by reference to the EBA Loan GL, "[…] at the very least double-check the input data used by the previous one, and not take it for granted. This includes descriptive elements such as the land registers. Further, adequate remuneration is key for ensuring the independence of appraisers and advanced banks follow related principles: for instance, the appraiser's remuneration should not be commensurate with the market value obtained. It is also considered a good practice if banks give appraisers enough time to verify the correctness of the information, to carry out market analyses and to collect proper comparable values";

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[15] This term is used by the ECB-SSM frequently in this article without defining precisely what is advanced versus basic, intermediate and so on. Suffice to say it would appear that an "advanced bank" is one that evidences good practice (as per the ECB-SSM's standards it communicates) on CRE risk management, excels in the operations of its control functions as well as IT and data systems and has a healthy active involvement of governance functions in CRE risk management as well as more broadly.

[16] See coverage from PwC Legal's EU RegCORE on the EBA Loan GL that the ECB-SSM expects BUSIs to implement and comply with.

- ***Content of the reports*** – As discussed above in terms of its findings, the ECB-SSM considers best-practice appraisal reports to be those that specify the basis of the value used (e.g., market value) and provide both a market value and a forced sale value to further highlight potential liquidity issues;
- ***Review of valuers' work*** - The review of valuations should ideally cover not only the assets pledged as collateral, but also banks' property assets (including foreclosed ones) registered at fair value, given the importance of these valuations in the capital ratios reported by banks. The review should be performed by banks' internal valuers meeting the qualifications required by the EBA Loan GL. Best-practice banks also ensure that the reviewer is independent from the credit origination process. They further document the review comprehensively for third parties to prove that the bank does not blindly rely on the valuation it receives;
- ***Hope value and special assumptions in valuations*** – those firms with advanced processes verify on an ongoing basis that the underlying assumptions are adequate. If discrepancies are identified, a new valuation should be requested in a timely manner and based on more robust assumptions. It is also a good practice if firms compare the outcome of these transactions with real transaction prices for similar assets, wherever possible; and
- ***Mortgage lending value*** – firms that are considered to have advanced processes do not rely only on mortgage lending values for risk management purposes. The ECB-SSM notes that they need to benchmark them with market values, which should capture liquidity issues.

***Integrating climate risk into credit risk management***

Accurate and comprehensive data are essential so as to accurately reflect and integrate climate risk drivers into credit risk management. While the ECB-SSM notes that there are structural issues affecting the availability and reliability of data, there are various steps that the ECB-SSM suggest could be taken to increase the available data.[17]

The ECB-SSM uses the article to remind readers that those BUSIs that were considered as applying best practice standards had introduced a mandatory requirement for collecting EPC data when granting loans. To address the lack of data on stock loans, some BUSIs also requested EPCs or other climate-related information when carrying out the annual review of borrowers and required valuers to collect the information when carrying out valuations. The ECB-SSM concluded that this was an efficient means of collecting EPC data given that BUSIs have a regulatory requirement to obtain up-to-date valuations every three years for large commercial real estate properties. Those that were termed "advanced banks" by the ECB-SSM also request energy consumption data from grid operators. These comments from the ECB-SSM will feed into the finalisation of its thematic review on climate-related and environmental risks and additional information will become available later in 2022.

## Outlook

The CRE Campaign and the CRE targeted review along with the first communications on good practice all mark an important, if still preliminary step, to building an entire new chapter in how the Single Rulebook for financial services in respect of CRE risk management is expected to be applied within the Banking Union. This is welcome in terms of driving consistency and certainty for BUSIs and the wider set of supervised entities as well as financial services firms more generally, if the ECB-SSM's efforts are rolled-out by other NCAs, in particular on improving data infrastructure.

However, the ECB-SSM is also clear that it will keep a close eye on emerging risks in the CRE and other "vulnerable sectors" notably having already identified aviation financing as another sector that will have a similar style OSI "campaign" and targeted thematic review applied to it. All of this may require firms to ready themselves as the ECB-SSM is clear that it will continue "connect the dots" for BUSIs to improve compliance with rules and supervisory expectations and will use both SREP and other sanctioning means to achieve its aims.

Equally, BUSIs will want to engage proactively with their appraisers, valuers and a number of other professional advisors to improve service level agreements and standard of work delivered to ensure the BUSI meets the ECB-SSM's requirements ahead of the ECB-SSM's publication on CRE collateral valuation practices across the EU and a benchmark exercise with the UK and EU.

[17] Including in the ECB Guide on climate-related and environmental risk see coverage from PwC Legal's EU RegCORE available here.

# About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website for access also to our real estate law and CRE market specialists.

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