Valuology

# Chris Thorne's Responses to Call for Evidence

## Valuation methodology

**1.**

**Should RICS be more prescriptive in the requirements it places on members to employ certain valuation approaches, methodologies and techniques in particular circumstances?**
No. It is the role of the valuer to understand and replicate how buyers and sellers in the relevant market determine the price they are willing to pay or accept. It is not to dictate to the market how it should do this. It would also demonstrate a lack of understanding of the dynamic nature of markets, and how at different times different factors will have a greater or lesser influence on value. It is for these reasons that the RICS, and other valuation standard setters such as the IVSC and the Appraisal Foundation in the USA have avoided prescribing what methods may be used ever since they first started issuing standards.

**2.**

**Would any increase in prescription on methodology lead to a reduced obligation on the professional valuer to reflect a particular market characteristic?**
Yes. Inevitably any prescribed method would reflect only what was considered appropriate at the time it was introduced. This could create a conflict if market dynamics changed at a future date and led to valuers not adjusting their method to reflect the current situation because of an obligation to follow the prescribed method. This would lead to the markets regarding the standards (and by extension the issuer) as being irrelevant to their needs.

**3.**

**Do the current applications of valuation methodologies meet market requirements – i.e. do valuations provide sufficient information to clients and others who rely on them about the factors that have influenced the valuation opinion?**

Two different issues have been conflated in this question. I answer them separately:

**Do the current applications of valuation methodologies meet market requirements?**
Yes. In 40 years as a practicing valuer and subsequently as an advisor on compliance and risk management I cannot recall a situation where a valuer did not apply, or attempt to apply, a method recognised by the relevant market. There are obviously cases where the valuation is been found to be incorrect because the chosen method or methods have not been correctly applied but that is a different matter.

**Do valuations provide sufficient information to clients and others who rely on them about the factors that have influenced the valuation opinion?**
They should do. It is a fundamental requirement of both the IVS and Red Book that reports include sufficient information to provide a clear understanding of the opinions being expressed by the valuer. This includes a requirement to explain the method(s) applied, key inputs used and the principal reasons for the conclusions. This requirement does not apply if it has been previously agreed with the client that no reasons are required. RICS has recently added the proviso that these reasons should be proportionate to the purpose of the valuation. I have come across many examples where inadequate reasons have been given to explain the valuation provided. However, this is a problem of compliance, not that the standards are insufficient.

**4.**

**Do the requirements of the Red Book / IVS create an adequate global/national framework for provision of high-quality valuation advice? Should RICS play a more active role in specifying the methodology to be adopted in certain circumstances?**

**Question 4.1: Do the requirements of the Red Book / IVS create an adequate global/national framework for provision of high-quality valuation advice?**

Yes. The purpose of the Red Book, IVS and valuation standards produced by other bodies, is to protect the public interest by ensuring that the client or others relying on the valuation understand the question being asked and how it has been answered. This needs requirements for the agreement of terms, the investigations required and how the valuation is reported. Most valuation standards have broadly similar requirements. These requirements set an adequate framework. It is fair to say that over the years the IVS and Red Book have added material that sometimes obscures these fundamental objectives and stray into valuer education but the framework remains there.

**Question 4.2: Should RICS play a more active role in specifying the methodology to be adopted in certain circumstances?**

No. While it is reasonable for a framework to require the adoption of recognised valuation methodology, specifying what methods must be used within this methodology* for different purposes would undermine, if not actually contradict, such a provision. The current VPS5 is more than adequate. It would be entirely inappropriate for the current responsibility placed on valuers to adopt, and as necessary justify, the valuation approach and the valuation methods used were replaced by centrally dictated methods. Not least is the question of who would be liable if the prescribed method was proved inappropriate in the circumstances?

> ** Methodology is the study or methods, or a system of methods. Methods are models or techniques that can be used to estimate value in different circumstances.*

**5.**

**Is there a need for additional guidance, training and data to RICS valuers to support the provision of high-quality valuation advice?**

There is a need for more focused rather than additional valuation guidance.

Training is perhaps a greater problem. It was disappointing to hear that valuation component of the foremost Bachelor's degree courses recognised by RICS has been reduced. RICS may need to see if there is anything it can do to increase the profile and interest in the subject in universities.

Another problem I have seen increase during my career is the trend for valuers to specialise in a particular sector too soon in their careers. This leads to many becoming so focussed on the detail of one market or micro market that they lose any ability they may have had to consider wider economic trends and how they could impact on their little sector of the market. I learned more about how markets operate and the need to think outside the box in the five years I spent as a commercial property agent than I did in my initial training and the remainder of my career. Perhaps firms should be encouraged to ensure young valuers get as much exposure as possible to different facets of the market before specialising.

**6.**

**Can professional valuers make better use of technology to deliver high quality valuations?**
Technology has been helping valuers improve the access to data and the calculation of valuations for at least the past 30 years, especially in the commercial investment markets. This has undoubtedly improved efficiency and reduced the time required (and with it costs) and there is no doubt this will continue. However, although increased efficiency in the process will help reduce the potential for errors, better technology alone does not necessarily mean higher quality valuations. What it can do is to free more time for the valuer to critically analyse the data and consider the bigger picture.

I am concerned at suggestions that AI will obviate the need for oversight by someone with expertise in the market and knowledge of all its nuances and trends. The financial markets have been using complex algorithms to value instruments such as securities and derivatives for many years. This is possible because of the sheer volume of data that is normally available and because of the homogenous nature of many products. However, I know from conversations with the Valuation Risk departments in global banks overseeing the values reported from their trading desks that what they are looking for are people who can "kick the tyres" by looking at the wider picture. This highlights the dangers of over reliance on such technology in a market as heterogenous as real estate.

**7.**

**Any other comments on valuation methodology**
Improve understanding that valuation methodology must include not only knowledge different methods and techniques required to estimate value but a thorough understanding of the fundamentals of economics and how markets need to be analysed to enable the most appropriate method to be selected and correctly applied.

## Property risk analysis

These questions focus on property risk analysis

**8.**

**Is there a potential conflict of interest for the valuer in providing a valuation figure for regulatory purposes and advice on future market changes?**
Unless the valuer is also retained to provide advice on investment strategy, see q10 below, there should be no threat to their objectivity. Valuations for regulatory purposes are spot figures, i.e. only valid on the valuation date. However, the estimated price represented by Market Value will, or should, reflect the views of buyers and sellers of future market changes so the valuer needs to be aware of and consider these. While care must be taken not to suggest that the reported regulatory value does not reflects the market's expectations on that date, there is no conflict in the valuer disclosing his view of future trends, even if these differ from those of many in the market.

**9.**

**Are valuations appropriately instructed?**
No comment.

**10.**

**Are valuations provided in a manner which gives clients sufficient, forward- looking quantitative analysis on risks and their impact on investment worth, in addition to the objective opinion of current value**

In my experience, funds do not ask their external valuers to provide qualitative risk assessments, or if they do, these are an entirely separate instruction from the valuation. "Worth" (aka Investment Value) takes into account matters specific to an individual market participants' business, investment strategy, financial profile and other matters. While a valuer may be involved in providing advice on the possible likely impact on value of future risks, this is not something that could or should be part of the regular portfolio valuations. While some standalone quantitative analysis can be provided, if the valuer, or valuers, firm become too closely involved in determining their client's investment strategy, this is a threat to their objectivity. The Red Book already requires the disclosure in valuation reports of any other material work the valuer's firm undertakes for that client, but if they are too closely involved in developing strategy and effectively taking on part of the fund manager's role, they should be declining the valuation instruction.

**11.**

**Can more be done to ensure clients understand how to instruct additional supporting, bespoke risk analysis?**

If valuers are clear as to the distinction between the task of acting as a standing independent valuer and providing bespoke risk analysis this should be reflected in the terms they agree with their clients.

I do see dangers in some of the recent papers from IVSC and RICS which suggest that valuers should take a "forward look" or adjust Market Value to some kind on "long term value". Much of what is written is inappropriately conflating the spot values required on a specific date and risk analysis, i.e. calculating the probability of loss arising because the current value changes in the future. Both services are required by the financial markets but the distinction between the two must be clearly presented and understood.

**12.**

**Do valuers have the tools to deliver this sort of analysis?**

Some do, some don't. Not all the skills needed for risk analysis form part of many valuer's initial training. Indeed for many valuers this would be superfluous as it would never be required in practice. However, those with a background in statistics or econometrics and access to the appropriate data will be able to provide this service.

**13.**

**Any other comments on risk analysis**

No further comments.

## Independence and objectivity

These questions focus on independence and objectivity

**14.**

**Are current RICS requirements in respect of valuer independence sufficient? This will focus on valuations for financial reporting (including investment portfolio performance measurement).**

The requirements for independence and objectivity in the Red Book are robust, although in my experience not widely understood, with members still failing to understand the difference between an involvement which is not a material threat to objectivity but which nevertheless needs to be disclosed and a conflict which means an instruction should not be accepted.

Specific provisions in relation to valuations on which third parties may rely, for example regulatory fund and financial reporting valuations were considered in the light of recommendations in the 2002 Carsberg Report. These identified additional disclosures for what were defined as "Regulated Purpose Valuations". These were first introduced as an amendment to the 5th Edition of the Red Book and were fully incorporated in the 6th Edition published in 2006. When the Red Book was subsequently split into "Global" and "UK Supplement" editions, some of these provisions were apparently deemed too UK specific. This has led to the original requirements and supporting guidance being divided between the two and rearranged in a way that has compromised clarity.

Another problem is that some valuers are adopting a "box ticking" approach to compliance with the independence and disclosure provisions and are not even aware of where some potential conflicts of interest can arise. While the fundamental requirements of the Red Book and the Conflicts of Interest Professional Statement are sufficient it is probably time to revisit how these are presented in the Red Book and the supporting guidance on the application of these principles to "regulated purpose" valuations updated.

**15.**

**Are there any other material threats to objectivity in valuation that RICS should consider?**

*I cannot identify any at present. The Review also needs to be aware of the inherent danger in RICS attempting to identify every material threat to objectivity. Members need to be encouraged to think about involvements that could represent an actual threat to their objectivity or that might be perceived by others as representing a threat. The fact pattern of every instruction will vary and involvement that might be innocuous in one may be material in another.*

*Some have suggested that independent valuers should be subject to the same criteria as auditors, who are under pressure to split their audit and consulting practices. I do not consider this is a valid comparison. An auditor is investigating and verifying all actions taken by the auditee that are reflected in its financial statements. In contrast the valuer is providing a single type of well-defined advice. Unless they advise the client on acquisitions and disposals, or wider management of the portfolio, which would be a clear conflict of interest and would disqualify them from acting as an independent valuer under current regulations, they have no responsibility to investigate actions which their client may take as a result of the advice received.*

*When this point was considered in the light of the Carsberg Report, the feedback from clients was that they wanted their valuers to be in firms that were also active in the market. The benefit of close contact between a firm's valuers and their agency/brokerage teams is clear at times when markets are disrupted and transactions dry up. In such circumstances understanding of the bid-ask spread*

*and of the general attitude of market players assumes much more importance than stale transaction evidence.*

**16.**

**Should valuation firms be required to provide details of their valuation governance structure within their terms of engagement?**

*In principle this is something which would help build confidence in valuations, providing the required structure and disclosure are proportionate to the valuation being undertaken.*

**17.**

**Any other comments on independence and objectivity**

*RICS can usefully seek to raise awareness of these issues. This does not require significant change to its existing requirements in either the Professional Statement or Red Book but of putting greater emphasis on ensuring that members are understanding and implementing them correctly. Liaison with other professions, and perhaps joint presentations on the subject, may be beneficial in widening RICS valuers' perception of where threats to objectivity may arise and when and how these may be mitigated.*

**Measuring confidence**

These questions focus on measuring confidence

**18.**

**How can RICS measure market confidence in RICS valuer performance on an ongoing basis?**

*This is not a straightforward thing to do as the response to any question that asks if valuations can be more accurate will inevitably be "yes". Perhaps the focus should be on the extent to which "the market" understands the process, in particular the investigations and research, undertaken by the valuer, and whether respondents would prefer more or less information about this in either valuation reports or published references to them.*

**19.**

**Should insights such as the Valuation and Sale Price Report be undertaken more frequently?**

*The Valuation and Sale Price Reports provide an interesting analysis of how valuations and prices compared over the course of a year, which in turn can be often explained by market trends at the time. However, these are historic and can be published more than twelve months after the end of the year being analysed, so their benefit to valuers or those relying on valuations is limited.*

*A fundamental issue, which is not really sufficiently highlighted, is that price and value are different things. While Market Value is an estimated price, it should reflect the view of a typical buyer and a typical seller, not the value to a specific party. The fact that different individual buyers and sellers often consider an asset is more or less valuable to them than the price they could obtain in the market is what drives transactions. Consequently an actual transaction price will reflect the advantages and disadvantages to the actual parties and can be expected to differ from a Market Value that is based on the views of market participants generally.*

**20.**

**Any other comments on measuring confidence**

*I have no other comments.*