Valuology

Comments on RICS Independent Review of Investment Valuations

Recommendation 1 – Commissioning and Receiving Valuation Reports

RICS should work with appropriate stakeholders in standardising governance arrangements for commissioning and receiving valuation reports for high-risk and 'regulated' valuations.

This recommendation follows a discussion about conflicts of interest and precedes one about valuer independence and rotation. We therefore assume the reference to "high-risk" valuations alongside "regulated" is referring to valuation assignments where there is either risk of a valuation not being seen or accepted as independent by those who will rely on it or that the risk of the valuation being wrong extends beyond any loss suffered by the commissioning party and has public interest implications. RICS coined the term "Regulated Purpose" valuations for these some years ago, but this only appears in the UK Red Book Supplement.

We do not think "high risk" is a helpful term in this context as it could imply that other forms of valuation are deemed low risk, and it would be totally counterproductive to allow such a distinction to be made. The current UK VPS3 provisions do need revisiting in conjunction with fund managers, regulators such as the FCA and FRC and perhaps auditors as 20 years have passed since the current rules were introduced. It is also fair to say that 20 years ago RICS was not able to go as far as the Carsberg Report had recommended because the client side was not that convinced of the need for change. If PP-G has judged it correctly there is probably more cross industry support for change now. Whether anything can or needs to be done at the global level is less clear, although it would be interesting to see if members valuing funds in different jurisdictions have to follow any specific regulations when valuing for funds or for financial reporting.

Recommendation 2 – Valuation and Advisory Activities

Valuers, with the support of RICS, should ensure that the separation of valuation from advisory activities within firms is consistently applied in respect of the use of valuation data and instructions.

Since PP-G has come down in favour of not separating valuation from a firm's other advisory activities, this is very narrow point about the need to keep client information, data and instructions secure. The need for confidentiality ought to be baked into members through the Rules of Conduct. In addition PS2 3.5 and 3.6 need no elaboration. However, we are aware of the tension between the need for valuers to get access to reliable and current transaction data and the confidentiality required of many agents by their clients. There is a paragraph (4.5) in the 2019 GN on Comparable Evidence explaining that complying with client confidentiality and statutory data protection doesn't mean that data cannot be used to inform the valuer's opinion, but perhaps there is a case for this guidance to be extended with examples of what is and what is not acceptable.

Recommendation 3 – Rotation

RICS should develop a time-specific, mandatory procurement and rotation process for valuers.

This was one of the Carsberg Report recommendations which was watered down, not least because clients placed more importance on continuity (and the associated time and cost savings) than the threat identified by Carsberg of over familiarity compromising the valuer's objectivity. As this has come more to the fore in statutory auditing, when coupled with the SG of ESG, there is probably the climate to strengthen this. However, RICS cannot control clients so this needs to be a collaborative approach with investor bodies and even the FCA. In the limited examples of which we are aware where a fund has changed the valuation firm on grounds of the need to rotate rather than to get lower fees, many of the individual valuers have moved across to the new firm, which rather defeats the object of having fresh eyes.

Recommendation 4 – Compliance Role

RICS should build on its existing 'RICS responsible principal' obligation by developing a Valuation Compliance Officer role to specifically cover valuation process and conduct.

This is a good idea in principle but there are obvious difficulties in extending this to smaller firms. PP-G says that he believes a compliance function done well within firms of valuers, multidisciplinary and sole practitioner alike, would considerably enhance society's confidence in property investment valuations. Is he therefore implying that the compliance should be just of "investment valuations", whatever they may be, or all valuations? If only of investment valuations, this makes the application to sole practitioners even harder to understand as few of them would have such a focussed business.

Even though many of the larger firms already have senior staff having compliance and quality oversight roles we know that they will have different briefs and responsibilities, so perhaps the first thing RICS should do is define what the Valuation Compliance Officer role entails. Once this has been agreed a decision can be made as to how widely this requirement is applied, and if necessary, how it can be achieved for smaller practices.

Recommendation 5 – Raising Concerns

RICS should ensure it has clearly signposted processes for its regulated members and other stakeholders to raise concerns about ethical conduct and address, amongst other issues, improper pressure placed on valuers.

There already is a process in place for concerns about ethical conduct by members to be raised with RICS. While there may be some RICS members who instruct valuers who might be guilty of applying improper pressure on them, the most egregious cases we have seen come from clients with no professional affiliations, so we are not sure how this will help the specific issue identified.

Recommendation 6 – Quality Assurance Panel
RICS should create a dedicated, independently led valuation regulatory quality assurance panel, under the jurisdiction of the RICS Standards and Regulation Board.

The raison d'être for the Regulated Valuer scheme was to identify those members qualified to provide valuations and to raise funds from those valuers via the registration fee to enable quality and compliance inspections to be undertaken. Between 2011 and 2017 this scheme was gradually rolled out and we are aware many firms, including clients of ours, which have had at least one inspection, and many have had two. The scheme was set up and its modus operandi approved by the Valuation Professional Group but since that has disappeared there is a gap here to be filled. We understand the assurance team currently reports directly to the SRB but having a more focussed and expert body in place may help in ensuring appropriate strategic priorities are set and followed.

Recommendation 7 – Valuation Audit Trail
The Red Book should include further standards around the conduct and recording of valuation instructions and meetings between client and valuer.

PP-G says he would like to see the rules made firmer. The rules for members on this are already clear and adequate – see PS2 3.12 – 3.15. He says he has anecdotal reports that the existing rules are not being complied with. We can confirm that is the case from the work we undertake. However, making the rules longer and louder does not solve this. Enforcing compliance does, see previous recommendation.

Comment on Red Book
Although not a numbered recommendation PP-G makes the observation in this section:

> *It was noted that the current Red Book is a daunting document, especially for clients, and that the reader might benefit from its structure being simplified to make it more accessible.*

This is in spite of a number of recommendations that the Red Book include additional provisions! However, we totally agree with the sentiment expressed above. It needs a complete rethink and questions answered such as why some RICS guidance is in the Red Book and some in standalone GNs and why the Red Book reproduces the IVS alongside its own standards, which may be similar in overall intent but frequently use different words and occasionally have material differences.

Recommendation 8

- **Analytical Approaches (i) Discounted Cash Flow**
  The valuation profession should incorporate the use of discounted cash flow as the principal model applied in preparing property investment valuations.
- **Analytical Approaches (ii) Advanced Analytics**
  RICS should improve the knowledge and application of valuers in respect of advanced analytical techniques.

We are aware of significant pushback on this. We find the examples leading to this recommendation quite muddled. This is possibly because discussions about entity specific value ("worth") are introduced, notwithstanding that the valuations required for most regulated purposes are based on the exchange price, i.e. Market Value.

Elsewhere examples are given where we cannot imagine that any trained professional valuer currently in practice would think appropriate. For example at the bottom of page 34 it says:

> *I have seen several examples in my own career of valuations not quite keeping pace with property development situations where value accrues over time, for example through the gaining of a planning consent or during building works. I recognise the difficulty of such situations for the valuer but feel that traditional valuation practice runs the risk of not fully capturing exchange price in such circumstances.*
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> *It seems to me that the discounted cash flow methodology, with appropriate scenario analysis, might well lead the valuer to conclude that the exchange price could reflect some of the future value a little earlier, whilst recognising that if the consent was not forthcoming, the valuation might fall back.*

Is he really saying that in the institutional market, which is the primary focus of this report, valuers are reporting the current value of development projects that do not allow for the time value of money and the risks inherent in the projections?

The basic principles of DCF are not new, they have been used in some sectors for over 100 years. They were certainly taught as part of RICS General Practice courses nearly fifty years ago. Yes, they have become more sophisticated and widespread thanks to computerisation, but while they allow greater analysis of actual market prices and fine tuning of predicted prices they are not always the only, or most reliable, method for estimating Market Value.

In the prime institutional property investment sector DCF is regularly used either as the primary route to value or as a check against other market-based valuation methods. This is because it is clearly a method that market participants use to make buy and sell decisions and the valuer should reflect this. However, this does not extend to all property investment sectors. An example is the type of investment sold by auction, where bidders will typically only making the most basic calculations about future income.

The job of valuers tasked with estimating Market Value is to replicate how typical market participants will decide on the price they are willing to offer and accept. It would therefore be wholly wrong for RICS, or any other body, to promote let alone prescribe the method

they should use in any particular situation. It can make sure members are aware of the different methods and techniques in use but that is for guidance, not part of mandatory standards.

RICS already produces a GN on Discounted Cash Flow for Investment Property (albeit now more than 10 years old) and in 2019 issued another on the Valuation of Development Property which explores three different methods, including DCF.

Another consideration is that there are many different models which apply DCF techniques, requiring different types of input to determine cash flows, appropriate time intervals or periods and discount rates, which have evolved to reflect the specifics of different types of market. It would be impractical as well as wrong for a body like RICS to attempt to produce authoritative guidance on every possible application of DCF techniques that members may properly need to use.

Recommendation 9 - Global Standards
RICS should maintain a record of valuation standards adoption and application in countries outside the UK where significant numbers of its Registered Valuers operate, in order to inform the extension of regulatory requirements and support to valuers.

We believe considerable work has already been done on this as in the course of our recent work we have found and used a number of RICS country specific guides on the applicable laws and regulations on valuation.

Where we do see confusion outside the UK is where valuers claim to be valuing in accordance with a pot-pourri of different standards regardless of potential contradictions or their respective status. There also needs to be recognition that the UK model whereby the Government is happy to effectively delegate regulation of professionals, including valuers, to professional bodies is unusual. In many more countries professional standards and regulations are determined by law. Even where governments decide to adopt standards set internationally, for example IFRS, in most countries these will still be subject of national approval and endorsement legislation which may contain some variation.

Recommendation 10 – Standardised Property Risk Advice
RICS should develop a framework to standardise property risk advice.

We are unclear exactly what is envisaged. The market's current view of risk is reflected in current prices so risk is an inherent part of valuation.

Some of the comments in the report come from fund clients who view the valuer's role as simply to provide independent advice on value at a specific date and not to get involved in advice on forward looking risk. That is probably a fair comment in context of the role of the SIV or AV under the UK fund regulations where independence from the instructing client is the key requirement. Others suggested they would like more information on future value, but this is not really the same as "property risk advice"

With lenders, the key concern is independence from the borrower or other parties interested in the property. Lenders frequently do ask valuers to comment on any risks they identify that could adversely impact on the current vale over the life of the loan. e.g.

potential voids, potential changes in the neighbourhood, traffic alterations etc, but this is to help them understand potential risks to the security over the life of the loan which they can then build into their models. PP-G's suggestion that property risk advice be provided in separate reports is not going to work in this case!

While there is a case for more guidance to valuers on the distinction between market risk (known unknowns affecting the relevant market on the valuation date) and potential future risks specific to the asset in question, we cannot see how a standardised framework can be created or how it could be used.

There is a wider issue of perhaps providing guidance on the valuer's role in providing strategic advice, including evaluation of matters specific to the entity to assist in wider risk management issues, but again this is far from being a standardisable product.

Recommendation 11 – Post-Qualification Requirements and Revalidation
RICS should review its post-qualification requirements for valuers and consider introducing mechanisms for regular revalidation of valuers.
We agree but not an issue for valuation standards.

Recommendation 12 – Diversity
RICS should continue to build on its important work to ensure a diverse and inclusive valuation profession.

We agree but not an issue for valuation standards.

Recommendation 13 – Culture and Behaviour
There is a need for further specific RICS guidance to clarify RICS' expectations around the culture and behaviours expected of RICS professionals in the pursuance of valuation activities

The New Rules of Conduct (effective January 2022) were not issued until October 2021 so it is assumed that the comments in the PP-G report were made before these were finalised. PS2 already has significant valuation specific content to augment the Rules of Conduct so it is unclear what specific gaps PP-G believes needs filling.