Research

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Identifying best practice for Regulation in conducting the valuation process, in accordance with RICS Valuation Standards, to mitigate valuation risk

Executive Summary

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Executive Summary of report for Royal Institution of Chartered Surveyors

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Executive Summary

This research was instigated and carried out by independent researchers from Northumbria University during Q3 2011 to Q2 2012. The indepth research and analysis are summarised here; the full report is available from the authors at the University. The analysis is based on the 2012 edition of The RICS Valuation Professional Standards (the Red Book). References to the Red Book relate to this edition, which has since been superseded by the 2014 edition.

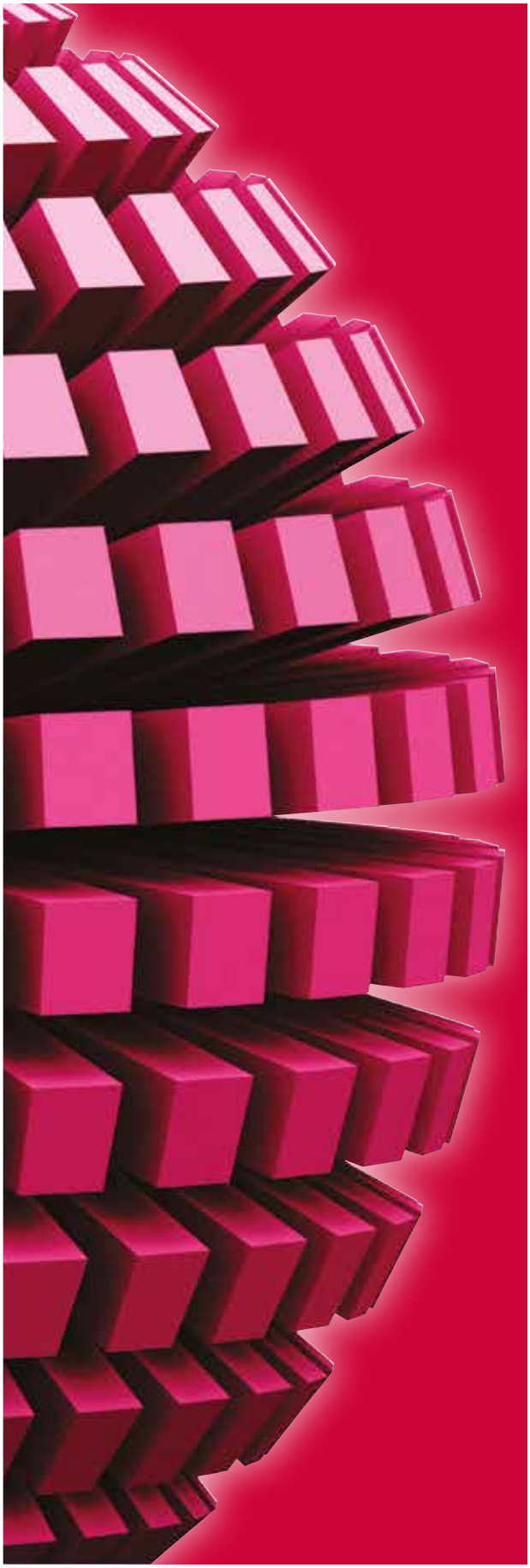
Under RICS Valuer Registration (VR) only registered members may undertake valuations to which the Red Book applies, and are monitored for compliance. RICS Regulation operates a 'risk-based' approach to monitoring, raising questions about the nature of the risks in the valuation process and their mitigation.

There is a widespread assumption, for instance in the Carsberg Report and in the VR, that Red Book compliance reduces the potential for valuation error and helps defend against negligence claims. However, failure to follow GNs and VIPs does not automatically entail negligence; there may be valid reasons for doing so, allowed for by the Red Book, and the valuation may anyway be within the acceptable margin of error.

The research aims to identify best practice in the valuation process, under the Red Book, to mitigate valuation risk for regulation purposes, by asking two research questions:

1. What are the risks involved in the 'Red Book' valuation procedures?
2. How can valuers manage risk to show compliance with the Red Book under regulation?

The risks were identified by reviewing valuation literature and analysing 99 reported valuation negligence cases. Interviews with valuers, solicitors dealing with negligence claims and professional indemnity insurance (PII) brokers provided information about current cycle risks and risk mitigation practice.



Risks in the Valuation Process

Overall, the research reveals the large number and wide variety of risks involved. The resulting data was mapped onto five defined stages in the valuation process, the risk profile of each being rated as low, medium or high and compared to the profile of valuers' risk management revealed in interviews.

In **Stage One** – ***"Identifying the valuation problem"*** risks appear to have increased in these areas:

- valuers working outside their sector, geographical or skill competences. Drivers include 'wanting to keep a client happy' and market-driven fee pressure. Interviews showed a strong emphasis on mitigating these risks.
- the potential risk of expanding third party liability when complex transactions spring from a single valuation.
- risk to valuer objectivity from clients 'opinion shopping' and coercive or reward tactics.

Stage Two – ***"Agreeing terms of engagement (ToE)"*** entails high risk. Increased risks arise from:

- poor quality ToE and their increasingly onerous nature and valuers' remoteness from lender clients when ToE's are issued through the panel system.
- risks associated with low fee levels: some valuers had "accepted loan security valuations at a fee disproportionate to the work involved in maintaining service quality".
- case law shows ToE present greater risk in valuations of complex commercial properties and valuations linked to preparing investment advice compared to residential valuations.

Of the five stages, **Stage Three** – ***"Data collection and verification"*** shows the highest level of risk in the research, exacerbated recently by fee and associated time pressure:

- the complexity, susceptibility to error due to behavioural factors such as anchoring bias, and potential for client influence in data collection and verification.
- errors in due diligence and inspecting the subject property.
- errors in collecting and verifying market data: "too many valuations per day; lack of time to do adequate research or check the comparables", "failure to record comps" and valuers "complacent about their preconceptions of value". Lack of transparent comparable data, especially in thin markets, and mortgage fraud were also cited as risks. The challenge of data quality and verification has changed subtly with new on-line data sources; access with a mouse click entails new risks of complacency.

Stage Four – ***"Valuation and reflection"*** also shows high levels of risk, especially in:

- analysis of market data and its evaluation and weighting in synthesis, especially in the face of data inadequacies which make assumptions necessary.
- failure by valuers to record clearly the data used and their reasoning in support of calculations, including justifying assumptions.

The high risks in **Stage Five** – ***"Reporting"*** focus on final report content:

- omissions of fact, advice or warnings about uncertainties in the valuation.
- incorrect statements about the market, property or valuation process.
- limitations on content due to lenders' short, standardised residential loan valuation report forms.

Having identified the risks in the valuation process, they were categorised as 'strategic' 'uncertainty' and other risks.

Interviews suggested some businesses choose to avoid risk, whereas others accept it as a strategy to gain market share and increase profits, albeit at the risk of operational pressure on valuers.

Examples of strategic risk taking include:

- undertaking buy-to-let loan valuations, a service line particularly prone to mortgage fraud
- accepting loan valuation instructions at a fee disproportionate to the work involved to maintain service quality
- reliance on panel managers for instructions, entailing vulnerability to threat of removal from the panel, and expectations of valuing to the proposed sale price.

A wide range of 'uncertainty risks' were identified, associated particularly with deficiencies in transactional and other market data. Examples include:

- difficulty in understanding market dynamics from historic comparable transactions at times of instability, especially timing and extent of market downturns
- lack of completeness or transparency in transactional and other market data, for instance the high number of relevant variables, lease terms, property size, condition and service charges
- manipulative supply of incorrect information or withholding of information from the valuer by interested parties, especially in mortgage fraud
- the numerous variables and need for multiple assumptions inherent in residual and trade related valuations.

Apart from the strategic and uncertainty risks, numerous other risks were identified, mainly resulting from human error and behavioural factors.

Risk Management

Risk Management (RM) and Quality Management (QM) are interlinked, the former aiming to reduce the risk of negligence claims and the latter aiming to improve service quality. RM and QM policies have to be robust, enforceable and monitored and at the same time appropriate and proportionate to the operation and risk appetite of each business.

Risk is usually mitigated through internal processes. Some risks can be transferred to another party through PII and severe strategic risks can be terminated, for example there is evidence of small firms changing their client base and withdrawing from secured lending valuations into expert witness and less litigious areas of work.

In the 2000s ISO 9001 encouraged checklist-driven QM systems, viewed by interviewees as helpful but inadequate for effective RM. More recently firms' RM and QM has been driven by PII requirements, involving controls more extensive than required by the Red Book or VR, with the result that firms and members engage in wider mitigation activity.

RM and QM policy should be addressed by senior managers and RM and QM cultures embedded in the business. Most interviewees execute RM and QM as part of their professional role but receive little relevant education. Larger firms usually operate more formal policies with specified staff responsible for implementation: some smaller firms with few staff resources found implementing effective processes more difficult. Interviewees said RM and QM processes should robustly control service delivery without inhibiting business initiative or operations and include supervision and training of professional staff.

The research found that the valuation profession in the UK has paid less attention to RM and QM than its equivalents in some other countries, resulting in a lack of UK relevant literature which RICS has only recently begun to address. The Red Book says little about QM processes, although it should be stressed that it is not intended to be a QA manual. Feedback from VR Pilot Reviews concentrates on generic advice on quality assurance and control processes to meet VR expectations, but does not grapple with the detail of processes or the wider mitigation of valuation risk. Valuation professional organisations elsewhere explain RM and QM in more detail, providing potentially useful exemplars for the UK.

The Red Book provides the framework for valuation best practice and the basis for VR rules and monitoring. Members had difficulty deciding about VR enrolment and the research shows the importance of clarity and alignment between the Red Book, VR rules and Regulation guidance. Since VR only monitors Red Book compliance, it is arguable that monitoring neglects important best practice and advice on RM and QM processes which is located elsewhere in separate guidance notes and information papers, for instance the Global Information Paper on Comparable Evidence in Property Valuation. This is a potential weakness in the VR approach especially relevant to Stage Three and Four of the valuation process.

Overall, the research reveals the wide variety of RM and QM activity being undertaken at each stage of the valuation process, much of it extending beyond the suggestions of the VR Pilot Review feedback. The full research report describes in more detail actions at each stage of the process and a range of subsequent audit processes for completed files.

Risk mitigation in Stage One – ***"Identifying the valuation problem"*** had recently assumed a high profile due to VR, with firms reviewing their service lines and implementing systems to monitor competence for Red Book valuations. Conflict checking was said to be long established but there was little evidence how they were managed once identified. Some firms were shifting their business model in response to increased litigation and to limit PII costs, terminating risk by refusing instructions, referring to specialists, withdrawing from risky service lines and weak client bases.

Risk mitigation in Stage Two – ***"Agreeing terms of engagement (ToE)"***, had a high profile but activity had to keep pace with changing risks in this stage and was resource intensive. Interviewees, alert to the extensive Red Book requirements, were embracing documentation and file recording systems. Wider activity included resolving assumptions and limitations with clients, securing appropriate fee levels and preventing fraud and money laundering.

Stage Three – ***"Data collection and verification"*** had a high profile of RM and QM activity associated with collecting and recording data about the subject property and the market. Interviewees widely used inspection checklists but templates for recording and verifying comparables were less standardised. Much RM and QM activity aimed to mitigate the risk of human error by effective supervision and training, developing a culture of sharing professional skill, acting diligently and objectively.

The Red Book framework deliberately says little about valuation methodology, as that is not its purpose. In so doing may be considered to limit VR monitoring for **Stage Four** – ***"Valuation and reflection"*** to the recording of key inputs, calculations and analysis. Interviewees stressed the importance of a written rationale and file management systems to retain all supporting evidence. Peer review, quality checking the valuer's judgements and opinion, was seen as a key risk mitigation tool satisfying PII and clients' requirements whilst combating valuer fraud and client influence. The research looks at the various models of peer review used by interviewees.

VR compliant processes in **Stage Five** – ***"Reporting"*** had a high profile with interviewees advocating report templates and robust file recording systems, giving clear advice and addressing uncertainty. Sign off procedures, an additional quality control process, were used by firms employing large numbers of staff.

Research Findings

Implications for RICS to consider

1. RICS and RICS Regulation may wish to consider the risks identified in this study.
2. Risk Management (RM) to reduce the risk of negligence claims, and Quality Management (QM) to improve the quality of the service output are not part of the function of the Red Book.
3. There is little literature covering the application of RM and QM systems to UK valuation and RICS could consider engaging more with these topics as do other property professional bodies, tailoring its advice to the resources and needs of both large and small firms. RICS Regulations could promote RM and QM.
4. RICS should work through university partnerships to enhance valuation RM and QM education and also reflect them in the APC Valuation Competency. Valuation RM and QM theory and practice should be developed and more widely promoted in CPD modules for qualified members.
5. The research suggests RICS provide guidance on Red Book compliant QM processes necessary to support VR. It would be advantageous to review the monitoring status of publications relevant for VR. For instance the Information Paper on Comparable Evidence falls outside the Red Book and yet its content is the subject of VR feedback on best practice, suggesting its status needs to be clarified.
6. The preparation of an information paper on the five stages of the valuation process as described in the research could usefully define the service for users, and put the Valuation Standards into context. It could provide the basis for a RICS resource area drawing together and identifying all global and UK IPs and GNs relevant to each stage of the process, to aid valuers in identifying relevant RICS information and guidance and thereby support risk mitigation.
7. Because VR registration rules and guidance on their interpretation are so important for firms' and members' earning capacity and business choices, it is important that ambiguous or inconsistent terminology is avoided when publishing the VR Rules, Red Book and other valuation publications.
8. The Red Book consciously excludes valuation methodology from its rules which means an important stage in the valuation process with a high risk profile for valuation accuracy, is not within the ambit of VR monitoring, other than the extent of its documentation. RICS and RICS Regulation may wish to reflect on the long term sustainability of this stance.
9. The research suggests RICS should continue pursuing the issues of PII and lending industry relationships, fees and terms of valuation instructions since these have recently introduced particular risks into valuation for secured lending instructions.

Implications for regulated firms to consider

1. Firms should be vigilantly aware of the risks in each stage of the valuation process and that mitigating the risk of negligence litigation by clients or third parties is not synonymous with mitigating risk of non-compliance for VR purposes.
2. Firms need to develop robust, enforceable and affordable risk management policies appropriate and proportionate to their business's size, operation and risk appetite, operated by a management structure suited to their resources. This may entail more robust systems than required by ISO 9001 and VR. Ongoing monitoring of RM and QM systems should inform their policies. Evidence suggests many firms are already moving in this direction, taking into account the requirements of clients, PII insurers and RICS.
3. Regulated firms' management structures and operational systems should be fit to implement effective risk and quality management, Red Book compliant processes and documentation for VR at each stage of the valuation process. They should monitor implementation and develop a QM culture of training, supervision, time management, support and open communication to create a transparent and objective valuation process.
4. The valuer's competence substantially underpins risk mitigation in the valuation process; firms therefore need processes to monitor their Registered Valuers' professional competencies and activity and offer effective support, supervision and training.

Implications for registered valuers to consider

1. Valuers need to be vigilantly aware of the risks in each stage of the valuation process and that mitigating the risk of non-compliance for VR purposes is not synonymous with mitigating the risk of negligence litigation by clients or third parties.
2. Valuers need more than ever to engage personally with the Valuation Standards in their entirety and other RICS valuation best practice publications, understanding their VR obligations,
3. Valuers should take personal responsibility for acting within their professional competence, despite pressures such as those from clients and time limitations, exercising diligence and objectivity and maintaining documentation to verify their actions.
4. Valuers need to proactively engage with and contribute to their firms' RM and QM culture and procedures, and consider using CPD to develop their understanding of these topics.

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