The Independent Review of Real Estate Investment Valuations – Call for Evidence

December 2020

Letter from Peter Pereira Gray
Chair, The Independent Review of Real Estate Investment Valuations

Dear All,

I am honoured to have been appointed recently by RICS to lead an Independent Review into Real Estate Investment Valuations.

Valuers and the users of valuations are working with significant structural shifts in investor sentiment and occupier demand for real estate which is changing the market place and public and regulatory expectations of valuers. In this context, the Review is fully warranted at this time.

Recognising the importance of this topic for society and RICS, I have appointed a diverse expert advisory group to bring experience and challenge to the review from a variety of different perspectives. I am delighted to welcome those panel members to the Review and thank them for their assistance.

As part of the process for the review we are launching a Call for Evidence. This sets out the context for the Review and the areas we are particularly interested in hearing your views on. We will welcome feedback until 31st March 2021.

We will submit a report to RICS at the end of the summer 2021 and will consider all the feedback from this Call for Evidence when forming any recommendations.

This is a very important topic and we encourage as many of you as possible to share your views on the areas set out for consideration in this Review. Thank you in advance to those who feel able to contribute.

Kind regards,

Peter Pereira Gray

Chair, Review of Real Estate Investment Valuations

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1. Introduction

Land and real estate assets comprise 50-70% of the national wealth of the world's economies[1] - much of global bank lending is secured upon these land and property assets. Valuation of these assets is therefore crucial for overall market confidence and economic stability.

RICS is the leading global professional body for property valuation services providers, with circa 16,000 registered, regulated professional valuers. RICS sets and maintains professional valuation standards that apply to RICS members and regulated firms globally. The standards are published in the RICS Valuation Global Standards (Red Book) with supporting guidance and insight. Along with RICS' own requirements, the Red Book incorporates the common, global concepts defined in the International Valuation Standards (developed by the International Valuation Standards Council) and provides an effective, regulatable framework for their delivery to clients.

Valuations produced by RICS regulated members underpin financial reporting and decision making for trillions of pounds worth of land and real estate assets in the United Kingdom and globally[2].

Recent structural shifts in investor and occupier demand for real estate[3], many accelerated by the impacts of COVID-19, have resulted in a changing market and public and regulatory expectations of valuers.

To ensure that RICS valuation standards remain a foundation for confident markets, the independent RICS Standards and Regulation Board, which has oversight of the RICS standards in the profession, has agreed that an external review is necessary to provide evidence-backed recommendations.

The review

In the Summer of 2020, the RICS Standards & Regulation Board appointed Peter Pereira Gray to lead an independent review into real estate investment valuations and to provide evidence backed recommendations. The focus of the review is on valuations commissioned for decision-making based on value criteria and includes, but is not restricted to, secured lending, financial reporting and valuations for regulatory purposes.

Peter has appointed a diverse expert advisory group from a range of different sectors, to support the process by providing robust challenge and insights. In addition, this Call for Evidence, alongside evidence gathering sessions, will help inform the review's findings and recommendations.

The review itself will specifically consider the criticism that has centred on the valuers' ability to keep pace with market changes, including:

- Changing occupational trends and their impact on investment in real estate

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[1] The Land and Real Estate Assessment (LARA), *The Lincoln Institute of Land Policy and The World Bank Group*
[2] MSCI, *Real Estate Market Size 2019,* https://www.msci.com/documents/10199/035f2439-e28e-09c8-2a78-4c096e92e622
[3] RICS, *Q3 2020: Global Commercial Property Monitor,* https://www.rics.org/globalassets/rics-website/media/market-surveys/gcpm/gcpm-q3-2020-final.pdf

- Institutional real estate investment becoming more widely understood to be an actively managed business activity, where the management ability has a material impact on worth/value
- Structural market change (rapidly evolving investor and occupier demand) – impacting on real or perceived valuation of assets. For example, the changing dynamics in retail
- The suspension of UK property funds at perceived market turning points
- Concerns over the independence of valuers from their clients when reporting on investment performance

The review will therefore examine the way valuations of property assets for investment purposes are conducted and gather evidence on four key areas:

1. Valuation Methodology
2. Property risk analysis (*also known as the 'forward look'*)
3. Independence and objectivity
4. Measuring confidence

This Call for Evidence sets out the framework for collecting the evidence on which recommendations will be concluded. It provides further information on the key areas in the following sections, including the specific questions that we would welcome views on.

Who should read this paper

The Call for Evidence will be of interest to a wide range of firms, regulators and consumers, including but not limited to:

- Valuation practitioners
- Valuation professional organisations
- Financial organisations
- Regulators and other authoritative bodies
- Governments bodies, policy makers, and think tanks
- Consumers and consumer organisations

How to get involved

We are inviting views on this Call for Evidence until **31st March 2021** and to help with the discussion we have put some questions for feedback throughout this document (a full list of questions can also be found on page 12). As part of this call for evidence, we may also meet or hold calls with stakeholders. To contribute to the review please go to our consultation site here or email your responses to valuation_review_2020@rics.org.

Next Steps

Following the closure of the Call for Evidence, the expert advisory group for this review, alongside the Chair, will analyse the discussions and responses, to make recommendations to RICS by August 2021. To find out more about Chair Peter Pereira Gray and the expert advisory group, go to the valuation review web page.

2. Areas for Review - Valuation Methodology

RICS applies valuation standards through the Red Book, which provides the core mandatory and advisory guidance for regulated members and firms providing valuation services. The Red Book was first produced in 1976 following the property and secondary banking crash of 1974. Since then, there have been multiple editions and supplementary guidance produced. These editions have been updated to include the high-level principles and definitions of the International Valuation Standards (IVS), acting as a one-stop regulatory framework for professional valuers. Additionally, the Red Book has changed over the years to become a principal-based set of standards that sets down minimum procedural requirements that follow the process of carrying out a professional valuation.

RICS registered valuers must comply with the Red Book. This includes members who are carrying out valuations on a range of assets. However, the Red Book has very limited requirements regarding the use of valuation methodologies, on the premise that the Red Book requires the person carrying out the valuation to have the required knowledge and competence to carry out the valuation assignment in question. It currently states:

Valuers are responsible for adopting, and as necessary justifying, the valuation approach(es) and the valuation methods used to fulfil individual valuation assignments. These must always have regard to:

· the nature of the asset (or liability)

· the purpose, intended use and context of the particular assignment and

· any statutory or other mandatory requirements applicable in the jurisdiction concerned.

Valuers should also have regard to recognised best practice within the valuation discipline or specialist area in which they practise, although this should not constrain the proper exercise of their judgment in individual valuation assignments in order to arrive at an opinion of value that is professionally adequate for its purpose.

Unless expressly required by statute or by other mandatory requirements, no one valuation approach or single valuation method necessarily takes precedence over another. In some jurisdictions and/or for certain purposes more than one approach may be expected or required in order to arrive at a balanced judgment. In this regard, the valuer must always be prepared to explain the approach(es) and method(s) adopted.

The Red Book however, does refer to four “approaches” to valuation:

1. the market approach (sometimes known as the direct market comparison approach)
2. the income approach
3. the cost approach; and
4. the asset-based approach

To facilitate these approaches, a valuer is required to adopt a range of methodologies and techniques. The Red Book does not currently prescribe these and does not give guidance for their application other than at a higher level for some specialist classes, such as assets valued by reference to trade (VPGA 4), where a “profits method” might be most appropriate. IVS also describes valuation approaches at a high level, rather than make recommendations about technique, although, it does give additional detail on the “residual method” used commonly in the valuation of development property. Generally, though current valuation standards do not mandate when, for example, a discounted cash flow or basic capitalisation of an income stream might be best used by the valuer or suggest particular valuation inputs - these remain the professional judgement of the valuer.

The purpose and basis of valuations determines which methodology is most suitable. Each method may produce a different valuation and in certain situations more than one method may need to be used. If valuers decide different methods, techniques and inputs are appropriate it can create inconsistencies in valuations, even where undertaken for the same purpose and basis. However, equally, prescriptive standards may not be suitable to cover the vast range of valuation circumstances, leading to unwarranted valuation conclusions in some circumstances.

This raises the question therefore as to whether RICS should be more prescriptive in the requirements. Would this help with ensuring consistency? Or are there too many different scenarios that prescription would make it harder for the valuer to consider market circumstances and apply their judgement?

We are interested in understanding more about your opinions on the application of valuation methodologies to valuations of real estate. We've set out some questions below which we would welcome views on.

Questions

1. Should RICS be more prescriptive in the requirements it places on members to employ certain valuation approaches, methodologies and techniques in particular circumstances?
2. Would any increase in prescription on methodology lead to a reduced obligation on the professional valuer to reflect a particular market characteristic?
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?
4. Do the requirements of the Red Book / IVS create an adequate global/national framework for provision of high-quality valuation advice?
5. Is there a need for additional guidance, training and data to RICS valuers to support the provision of high-quality valuation advice?
6. Can professional valuers make better use of technology to deliver high quality valuations?
7. Any other comments related to valuation methodology

3. Areas for Review - Property risk analysis (the "forward look")

The methods used in valuations have a common trait - they all use comparative, available data, to produce a current valuation to the basis of value agreed with the client, which is often perceived to be backwards looking.

Comparable evidence is at the heart of virtually all real estate valuations. Whilst the transactional data for comparison may be based on known records rather than sentiment or prediction, it is important to remember that the comparison captures the forward view of the parties at the time of the deal. The process of identifying, analysing and applying comparable evidence to the real estate which is being valued is, therefore, fundamental to producing a robust valuation that can stand scrutiny from the client, the market and, where necessary, the courts.

Using comparable evidence ensures immediate accuracy and is the dominant basis for many valuations. However, the global financial crisis highlighted the limitation of relying on market value in the case of a severe market downturn. As a result, clients are increasingly asking for the long-term, future value or a property risk analysis. Similarly, given the impact of COVID-19 and the volatility which can be present in market cycles, investors potentially need to take more risks, and the question arises of how valuers can best use their knowledge, skills and valuation framework to assist clients in these situations.

For certain assets and markets, the income approach to valuation (sometimes referred to as the investment method) is the most suitable. This provides an indication of value by converting estimated future cash flows to a single current value[4]. Although by its nature, an element of forward looking is required for this method, projections are usually based on an analysis of past and current data. Evidence in respect of the income approach may be taken from various sources relevant to a particular market. For example, the rent roll and rent collection details. Sometimes the income approach requires a forensic review of the accounts for the occupier of the asset being valued and may also refer to benchmarking details and comparable evidence relating to other operators and assets. While this approach is more forward looking, structural and behavioural changes in markets can cause uncertainty around future income streams. The more unknown these effects are and the longer the expected duration of uncertainty, the greater challenge there is with the use of the income approach.

For valuers, there can be a reluctance to engage in the discussions around a property risk analysis and the forward look, because it can be more of a prediction than valuation. This is naturally riskier for the valuer than assessing current market value and raises liability consequences. Valuation is also often a regulated activity, whereas advice may not be. It is therefore important that when clients instruct a valuation, it is done so appropriately, so the expectations are clear. Question arise though, as to whether more can be done to ensure clients understand how to instruct a supporting risk analysis? Or whether valuations provide a sufficient forward-look analysis?

We are interested in understanding more about property risk analysis. We've set out some questions below which we would welcome views on.

[4] IVS 105, 40 the income approach

Questions

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?
9. Are valuations appropriately instructed?
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?
11. Can more be done to ensure clients understand how to instruct additional supporting, bespoke risk analysis?
12. Do valuers have the tools to deliver this sort of analysis?
13. Any other comments on risk analysis.

4. Areas for Review - Independence and objectivity

Valuation by nature involves different parties with specific interests and the effective identification and management of any conflicts of interest is a challenging but essential part of being a professional valuer. The Red Book recognises this and sets out that members must bring the required levels of independence, integrity and objectivity.

Valuers need to mitigate the risk of a perception that their opinion has been influenced. The valuation file must be able to confirm the independence and objectivity of the valuer and checks should cover the valuer, the firm, the property, and the client. One of the key requirements of RICS valuation standards is that the valuer informs the client that they have completed the conflicts of interest check and they must include a statement to this effect in the Terms of Engagement and include a further statement to this effect in the final valuation report. In addition to the Red Book, all RICS members have to adhere to the Rules of Conduct and certain, global, professional statements. This includes a professional statement on conflicts of interest.

However, there are questions over what constitutes a conflict of interest. For instance, there have been questions raised about firms who are appointed be the valuer on a fund or for a company's assets while at the same time the firm is employed by the company for other consultancy services. While different people may be undertaking the different activities it is still one firm – does this constitute a conflict of interest?

Firms argue that having access to colleagues working in other parts of the business such as investment advisory helps them to ensure the accuracy of their valuations as they are getting more up-to-date evidence, which in turn is ensuring that they are delivering the best service to their client. If this is acknowledged, is this sufficient for the purpose of ensuring objectivity but delivering an accurate valuation? Or does more need to be done to ensure there are no conflicts of interest? Are any further requirements needed to ensure objectivity and independence? Would ring-fencing areas of business provide sufficient independence or just reduce the accuracy of the valuation?

We are interested in understanding more about independence and objectivity. We've set out some questions below which we would welcome views on, and in particular would welcome evidenced, real-case scenarios.

Questions

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

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

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

17. Any other comments on independence and objectivity.

5. Areas for Review - Measuring confidence

Among other reasons, standards are set to ensure consistency, however it is crucial that they are changed when necessary to reflect market need. As stated in the previous section, there have been several editions of the Red Book Valuation Standards since they were first introduced, with the latest global update effective from 31st January 2020. Each of these changes has adapted to changes in the market to ensure the highest global standards.

RICS undertakes a series of different initiatives to ensure they are able to understand the market, such as market surveys, with input from RICS Professionals to ensure that they have an understanding of the market dynamics, Leader's Forums, Expert Working Groups, Advisory Forums and informal engagement with a wide range of stakeholders, as well as conversations on the RICS Insight Community. RICS also undertakes research, such as valuation and sale price reports to measure valuations against sale prices[5]. These initiatives, among other purposes, aim to ensure that the Standards remain fit-for-purpose in maintaining confidence in the valuation profession.

As a result of COVID-19, structural changes to the real estate sector are being accelerated[6] – businesses are looking to change the size of their real estate footprint in most major centres, adding to doubts about the value of property in the current environment. Given this accelerated changing landscape and the immediate impact of COVID-19, are there mechanisms that RICS could use to measure confidence in valuer performance on an ongoing basis? Are there different measures for short- and long-term confidence?

We are interested in understanding more about how RICS could measure market confidence of valuer performance on an ongoing basis. We've set out a specific question below which we would welcome views.

Questions

18. How can RICS measure market confidence in RICS valuer performance on an ongoing basis?
19. Should insights such as the Valuation and Sale Price Report[7] be undertaken more frequently?
20. Any other comments on measuring confidence.

[5] RICS, *Valuation and Sale Price,* https://www.rics.org/globalassets/rics-website/media/knowledge/research/insights/valuation-and-sale-price-march-2019-rics.pdf
[6] RICS, *Q3 2020: Global Commercial Property Monitor,* https://www.rics.org/globalassets/rics-website/media/market-surveys/gcpm/gcpm-q3-2020-final.pdf
[7] RICS, *Valuation and Sale Price,* https://www.rics.org/globalassets/rics-website/media/knowledge/research/insights/valuation-and-sale-price-march-2019-rics.pdf

6. Call for evidence questions

We are publishing this Call for Evidence to understand the issues around real estate investment valuations. We would welcome view by **31st March 2021**. In particular, as mentioned above, we are interested views on the following questions:

Valuation Methodology

1. Should RICS be more prescriptive in the requirements it places on members to employ certain valuation methodologies in particular circumstances?
2. Would any increase in prescription on methodology lead to a reduced obligation on the professional valuer to reflect a particular market characteristic?
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?
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5. Is there a need for additional guidance, training and data to RICS valuers to support the provision of high-quality valuation advice?
6. Can professional valuers make better use of technology to deliver high quality valuations?
7. Any other comments relating to valuation methodology.

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?
9. Are valuations appropriately instructed?
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?
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Independence and Objectivity

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16. **16.** Should valuation firms be required to provide details of their valuation governance structure within there terms of engagement?
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Measuring Confidence

18. **18.** How can RICS measure market confidence in RICS valuer performance on an ongoing basis?
19. **19.** Should insights such as the Valuation and Sale Price Report[8] be undertaken more frequently?
20. **20.** Any other questions relating to measuring confidence.

To contribute to the review please go to our consultation site here or email your responses to valuation_review_2020@rics.org.

[8] RICS, *Valuation and Sale Price,* https://www.rics.org/globalassets/rics-website/media/knowledge/research/insights/valuation-and-sale-price-march-2019-rics.pdf