Valuation, Market Evidence and Pro-Poor Finance

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SUMMARY

This paper reviews the nature of '*value'* (when compared to '*cost'*, '*price'* and '*worth*') and explains why valuers achieve their individual '*opinions of value'* . The valuation process relies almost exclusively on market evidence. In underdevelopment markets or markets where land transactions are not recorded the ability of valuers to access suitable transactional data is severely limited which means that they are unable to provide reliable valuations.

This is of major concern in locations where those who live in informal settlement are unable to use their real estate because lending institutions require the traditional title deeds and a valuation as a means of limiting the risk to lenders. Yet there is evidence that such communities are '*wealthy*' and the inability to use this '*wealth'* to improve their conditions, to meet their needs and aspirations, is perpetuating an unsustainable situation.

The paper reports on the outcome of a 2008 FIG seminar in Stockholm where alternative ways of lending have allowed those who live in informal settlements to prove their credit worthiness and raise funds for their own projects. It also reflects on the potential for valuers and valuation services to support such communities in their goal of sustainable communities.

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1. INTRODUCTION

Valuers are the interface between other land and building specialists and the rest of the commercial world. They provide an opinion of '*value'*, which can be defined *'as the relationship between something owned and an individual or individuals who wish(es) to own it.'* (IVSC, 2005: GN 1 para. 5.1)

They have a high degree of expertise in the physical, legal, economic, and social aspects of land and buildings, together with a detailed understanding of the demand-side within a trading market. Indeed, it is important to remember that what is being valued is not the land and buildings etc. on the land, but a defined bundle of legal rights, restrictions and responsibilities in that land and buildings (Enemark, in FIG 2008: 18). Inevitably, value varies with the nature of the bundles of rights, restrictions and responsibilities just as it is likely to do so with different (physical) parcels of real estate.

Valuers appreciate the needs of a range of users and investors of real estate, as well as those of other third party stakeholders, including the wider community, local and central government agencies, and financial organisations. They can communicate effectively with these disparate groups. They translate the need for and uses of real estate into monetary value, for a range of purposes, and thus provide an important service for all land users who need to have a monetary equivalent for real estate holdings.

Valuers understand what many users and purchasers of real estate may not. They are aware, for example, that *'value'* in terms of what valuers estimate, must be distinguished from '*cost*', '*the amount required to create or produce the good or service'* (IVS 2005: para. 4.3) and '*price'* which may be defined as '*the amount asked, offered or paid for a good or service* (*ibid.,* para. 4.2; see also RICS 1997). Both cost and price are matters of fact, whereas '*value'* is a matter of opinion. While the price paid for real estate may be based on one or more valuations, there is no requirement that this should be the case; and there is certainly no likelihood that cost has any bearing at all on value.

Valuation is, however, not a perfect science. Indeed, it is often described as both art and science. Valuers rely on data from market transactions in order to determine their opinion of value. The quantity, detail, availability, reliability and transparency of data regarding transactions vary in different jurisdictions. However, it is never possible to have perfect knowledge in interpreting market transactional data. Valuers therefore are required to supplement their knowledge with assumptions (which they should state clearly) in order to complete their valuation.

Regardless of this, there are well recognised valuation methodologies on which valuers rely to fulfill their professional roles. However, increasingly, these methodologies are being put under pressure, because they are not adequate for an increasingly important and socially-crucial function – that of providing an appropriate *'value'* on which financial companies are prepared to lend money in locations where there are no formal markets, or where the market is underdeveloped.

This is an urgent problem which valuers in general and FIG's Commission 9 needs to address. This paper provides an outline of the issues for valuers and for the wider commercial / financial sectors involved.

2. VALUATION

2.1 Valuation Defined

Within the profession, we have a very strong understanding of what a valuation is. We also have specialist guidance from a number of authoritative sources.

For example, according to the International Valuation Committee (IVSC 2010: para 10):

'The word valuation can be used to refer to the estimated value (the valuation conclusion) or to refer to the preparation of the estimated value (the act of valuing).'

So, '*valuation'* is both what we do (process) and what we produce (output). But the important point about this definition is that valuers provide an '*estimated value'*. The conclusion of our work is not a fact, but an opinion, and it is very likely that different valuers may well have different opinions as to the value of any given piece of real estate. This is partly because an opinion of value relies not only on the subjective observation and analysis of the nature and 'valuable' attributes of the property to be valued (the subject property), partly on the nature, quantity etc. and the other appropriate data regarding transactions in the market available to the valuer, but also on the relevant and relative skills, knowledge and experience which each individual valuer brings to the task.

Thus, a valuation can perhaps be more accurately defined as: '*a statement of opinion of the monetary worth of an asset by a recognised, skilled and experienced practitioner, at a point in time, reflecting prevailing market conditions and within defined criteria.*' (Gronow and Plimmer, 1992: 23).

We do not produce a certainty, merely an opinion based on our professional skill, available knowledge and experience, which we can be required to justify based on the relevant facts presented to us – both in terms of the property which we are asked to value and the other significant data on which we rely. Some valuers may have access to more or less data than others who may be required to provide a valuation of the same subject property. Alongside the issue of data availability is experience and comprehension of property type and location.

Our relative skills and experience may cause each one of us to attribute more or less weight to different pieces of information, although it is not likely that the methods we use to arrive at our valuation will vary greatly.

Given that each one of us has a different breadth and depth of knowledge and experience of valuation principles, practice, as well as of property types and locations, it is not surprising that our opinions of value may vary – indeed, it is only to be expected. As Crosby (2000: 158) points out:

"the nature of the beast is that some variation will occur and 'experts may differ without forfeiting their claim to professional competence'."

However, what is much more important is that we should be in a position to explain to clients or other stakeholders how we have arrived at our valuation, and ensure that users of our services understand the constraints involved. It is also important that they are made aware of the circumstances under which our opinions may change – for example, over time and, as indicated above, different purposes may have different *'values'*.

1.2 Purpose of Valuation

It is well known that it is not possible to provide a valuation for real estate without knowing the purpose for which that valuation is required. Indeed, it is said that there are as many values for a property as there are purposes for which a valuation may be required (see, for example, Millington, 1988: 39).

It is therefore extremely important that the stakeholders who will be using the valuation are aware of the differences between, for example, a value for insurance purposes (which is based on the theory of costing a replacement building in the event of its damage or destruction) and a value for tax purposes (which is the statutorily defined '*assessed value'*, and which may bear no relationship at all to saleable value), and a market-based valuation for the potential sale of the asset.

3. MARKET VALUE

However, it is generally the case that, when asked to value a property, the valuer is expected to provide '*market value'* i.e. '*the price that would be achieved in a hypothetical exchange in a free and open market'* (IVSC 2010, IVS 103, para. 3). More specifically, '*Market value is the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.'* (*ibid.* para. 6).

The IVSC (*ibid.*) provides a detailed explanation for this definition, from which it is clear that the valuer must rely on the evidence of sales of comparable properties in order to provide a

valuation. This raises a number of issues.

3.1 Heterogeneity of Real Estate

All real estate is unique, if only because of its location. Even neighboring properties will have some differences and the extent to which these differences affect the saleable value affects their use as comparables.

In some cases, these differences will have a minimal effect on value as in the case with apartments in multistory developments. However, even here, variations in price may be expected to reflect views (or the lack of them), aspect and also cultural preferences (e.g. in Chinese cultures, floor 8 may be considered popular, whereas floor 4 is considered unattractive, just as floor 13 may be considered undesirable in Western cultures.)

It is also true that residential property may have a subjective attraction for certain potential purchasers, and such personal preferences may not always be clear from or reflected in previous transactions for what would otherwise seem to be similar properties. The ability of a valuer to interpret and isolate such apparently '*valuable'* attributes may be limited, unless the individual purchasers have explained the rationale behind the price they paid.

3.2 Availability of Transactional Data

Using the evidence of earlier market transactions requires that such data be available (ideally freely and publicly) to valuers. Such data should cover all property types in all locations, and should include all relevant and valuable attributes so that a comprehensive and detailed analysis can be undertaken. Ideally, valuers should have first hand knowledge of both the property to be valued (the subject property) and the properties in all relevant transactions.

This, of course, is rarely the case. It is most unlikely that any available transactional data will cover all property types, simply because not all property types are disposed of in any form of market, open or otherwise. Data may not be either freely or publicly available. Relevant and valuable attributes may not be recorded. Dates of sales may reflect different economic circumstances which render the sales inappropriate for comparison purposes. Time and location are major factors in the selection of comparables.

Thus, the vagaries of the market may defeat the valuer who is searching for a recent transaction of a particular property type in any given location. If there have been no such transactions, there can be no evidence on which to base a valuation.

This is, of course, one of the reasons why valuers need high levels of professional education and skills, both in order to interpret the market evidence when it is available and to provide as reliable a valuation as they can where such evidence is absent.

4. IN THE ABSENCE OF A MARKET

There are a number of circumstances in which a valuer must work without the benefit of market transactional data to support what must still be called an open market value. Such circumstances include:

(a) a property type which is seldom if ever traded in the market; and
(b) market transactions are not recorded or are not available to the valuer.

Thus, both the nature of the property itself and the absence of any market infrastructure to provide relevant transactional data may restrict the ability of the valuer to follow what would otherwise be regarded as a normal valuation methodology.

4.1 Specialized Properties

There is guidance available to valuers in the case where a property is of a type which is rarely if ever sold in the market except as part of the sale of the business, known as '*specialised properties'*. The use of a Depreciated Replacement Cost methodology (IVSC 2010, 201.05, para. 6) is acceptable for such property types, in this case, specifically in order to provide a '*fair value*' of operational property for accounting purposes. Such a methodology may also be adapted for the valuation of such properties for other purposes.

However, as shown earlier in this paper, cost is a matter of fact and has no direct bearing on market value. Indeed, the methodology is effectively designed to produce a highly personal statement of '*worth'* to the existing owner or occupier. It is not a substitute for a valuation using market transactional evidence, although '*fair value'* may be defined as equivalent to a market value.

4.2 Under-Developed Market – Valuing for Sale

However, in the case of an under-developed market, where transactional data is either absent (unrecorded), limited, confidential or simply not available, then valuers are forced to supplement their skills with other resources.

If it is simply a case of estimating a price for the future sale of a property, then there is likely to be an opportunity for '*testing the market'* by proposing a '*guide price'* and seeing how the potential purchasers in the market respond, assuming that there is demand and an opportunity to make the availability of the property known to potential purchasers. The process of sale by auction is a good example of how this can be done.

With time, and further transactions, a valuer can build up a body of evidence, based on professional experience and individual involvement. Such data is likely to record all relevant details, including those valuable attributes which attracted demand from the potential and actual purchasers.

Valuers working within the same location may pool their individual resources to develop a communal data base. Alternatively, they may share information on a casual basis, supporting each other but without developing formal links.

However, in an under-developed or informal property market, there may be few recorded sales and trends in prices are likely to be volatile, which makes the valuers' job of interpreting and analyzing market data, fraught with difficulties.

There is emerging evidence (e.g. FIG, 2012) that real estate can change hands in an informal environment, between a willing seller and willing buyer, who may avoid the involvement of (either legal or property) professionals for a range of reasons.

It is, for example, not unusual for governments to seek to levy taxes on sales of land. Carrying out informal transfers of land (where the occupation in fact changes, but without any formal recording of the deal) in order to avoid tax liability is an incentive in jurisdictions which do not have formal land registries of title (or a cadastre) or some additional device to avoid under-recording of sale prices, particularly where inhabitants are not wealthy.

What matters for the valuation profession is that without formal records of what is sold and for how much, there is no data on which to seek to replicate the activities of the market in preparing an estimate of value. Valuation therefore risks becoming an unreliable process and product and local communities (owners, occupiers and other stakeholders) are not able to benefit from the added value which professional services can offer..

4.3 Under-Developed Market – Valuing for Loan Purposes

Of course, as indicated above, not all valuations are provided for sale purposes. Increasingly, in under-developed and informal markets, stakeholders are seeking to use real estate as collateral for loan purposes. Property owners (or apparent owners) are keen to optimize their property rights in order to raise money, perhaps for home ownership, or commercial operations, to improve their economic prospects; and banks and other lending institutions may be keen to support such economic growth.

Where there are developed active and 'healthy' property markets, real estate is generally used as collateral for loan purposes. The lending financial institution holds the title deeds of the property on behalf of itself and the legal owner as security for the repayment of the loan, and relies on a valuer's opinion of the likely resale price of the asset, assuming that the property is to be sold relatively quickly (as a forced sale), when deciding how much to lend. This is a device simply to minimise the risk of loss to the lender. The absence of a property market and of formal system of title removes this mechanism by which financial institutions can secure their loan on an authoritative valuation of the asset, and hold the title deeds of the asset as security.

Although this is a traditional and recognised means of reducing risk for the lender institutions, what really matters is that the borrower has the necessary capability to repay the loan – taking

the real estate as security is simply a guarantee, which financial institutions have become used to taking. Thus, the value of real estate as a form of collateral, specifically, the certainty that any foreclosure and resale of the property will at least recover the debt (plus, presumably, interest and costs), is paramount for the lending institutions.

Thus, the traditional way of lending and reducing the lenders' risk obstructs the raising of capital in locations without of an open, active, reliable property market (and potentially also no formal title system), and this is seen as a major problem for those who live in informal settlements, generally those on low-incomes, and where markets are underdeveloped. New ways of reducing risk which do not rely on formal land holdings should be developed in conjunction with the communities involved, in order to encourage the kind of social and physical environment to which informal and slum dwellers aspire and which reflects their needs.

5. **ISSUES**

'*Without access to affordable finance, poor people are caught in a vicious cycle in which affordable housing is inadequate, but adequate housing is unaffordable.'* (FIG 2008: 8)

In addition, finance is not available for economic activities which support communities, generating employment, goods and services. Municipalities also may find difficulties in raising funds for local infrastructure, which perpetuates the difficult living conditions of the communities.

In June 2008, in Stockholm in Sweden, FIG, UN-HABITAT and the Global Land Tools Network held a joint seminar entitled *Improving slum conditions through innovative finance*, which resulted in a major FIG publication (FIG 2008). This event brought together a number of people with different experiences of developing systems to share their experiences of how those who live in slum and informal settlements can raise finance to construct homes for themselves and their communities.

It is clear that the traditional method of securing loans is not relevant and that financial institutions and other stakeholders need to rethink the process in the light of reality.

As indicated above, what really matters to lending institutions is that the loan is repaid. Thus:

'*it is critical to demonstrate that the poor have the ability to repay and to save, in order for banks to have a better understanding of their capacity … Building trust [is] paramount.'* (FIG, 2008:29).

In addition: '*people need to be able to access credit without having to risk their land asset.'* (FIG, 2008: 30) This requires a complete rethink of the traditional lending theory and aprocess from financial institutions, yet there is evidence from the Seminar that this is already happening.

According to Mutter (FIG, 2008: 34), there is evidence of potential wealth within slums. He described what he called the '*slum investment deficit'* which is:

'*the contrast between what poor people can do and put up with in an environment where they are not formally accommodated or sometimes even acknowledged, even though they provide the city with its base resources, namely the labour and entrepreneurial skills that support the city economy. ... Slum dwellers are the investors in the urban economy and the* 'authorities*' do not keep up with them. The slum dwellers have incredible resources, and the slums have tremendous unrealized value. To be productive they need investment.'*

It is by providing opportunities for '*slum dwellers*' to use their '*unrealized value'* in order to generate investment and therefore productivity that the currently lop-sided '*slum investment deficit'* will be redressed to increase the prospects of achieving more balanced and sustainable communities.

Mutter continued (*ibid.*: 36) to identify the three basic requirements for slum upgrading and prevention:

1. land availability and security, which means protection from eviction for occupiers;
2. municipal responsibility for basic affordable services;
3. access to formal and affordable lines of credit specifically for slum dwellers' own projects.

There is evidence that savings schemes and cooperative structures contribute to the understanding of financial lending institutions as to the containment of risk to which they will be exposed and many of these are presented in the FIG (2008) publication.

However, it is clear that the slum dwellers themselves must be part of the solution, so that what is achieved reflects their needs and the process reflects their views. Other stakeholders would include national governments (which need to identify financing for improved accommodation) is recognised as a priority with their development plans; local and international banks need to incorporate the financing of upgrades as part of their core business, recognising the need for short- medium- and long-term loans; opportunities for community-based saving and loan systems; and local authority commitment to provide '*in kind'* and financial support, as well as services (Mutter, in FIG 2008: 37). All of these should be supported by relevant professional advice.

It is important to ensure that the costs and commitments involved are clear and transparent, and that risk is shared between all stakeholders and that all parties are involved in risk analysis, planned risk mitigation and management. Subsidies need to be targeted effectively. Projects with revenue-generating elements maximize financial viability as well as contribute to local economic vitality (*ibid.*).

6. CONCLUSIONS

It is the failure of the system of traditional financing processes to reflect the needs of the poor in informal and slum settlements which means that communities have no opportunity to help themselves out of poverty. While valuers play a part in the traditional lending procedure, it is only by providing a specific service to lending institutions – they are not involved in the underlying lending process and therefore have limited influence for change here.

It seems that existing formal and informal property markets and the systems and stakeholders which support them are failing to provide adequate access to land and accommodation for communities, and may represent the '*bottleneck'* which destabilizes secure long-term urban development.

Land is, of course, a fundamental source of wealth – indeed, it can be argued that it is the only fundamental source of all economic activities. In providing secure access to land and to the finance necessary to generate wealth from land, those who live in city slums have the opportunity to improve their lives and their prospects. By providing improvements within a community, the value of land in that community increases, thus increasing the opportunities for accessing further capital based on that wealth.

Land values can be taxed which in turn provides improved services which themselves add to the value of land, creating a virtuous circle of benefits. Provided that levels of taxation are fixed at a level which reflects the ability of the community to pay and that the income is spend on local services, it is probable that value will be added to the real estate which benefits from the services.

'*[T]axation is an indispensable tool that should be used to collect revenue to be reinvested locally so that people see the immediate and local benefit. Consideration should be given to the needs of the taxpayers and not simply to those of the legal owners.* (FIG, 2008: 33)

Valuers are well placed to help devise such beneficial tax systems.

However, in providing a degree of '*wealth'* through access to land rights, there is evidence (FIG 2008: 29) that '*... the rich were capturing the majority of the land value increase due to titling.'* Thus, issues of corruption and market manipulation must not be allowed to obstruct informal settlement dwellers from using land to improve their circumstances.

However, in this regard, the valuation profession has the necessary skills to help support communities and other stakeholders in making the most of the land and buildings they occupy, to provide services which add value, and allow them to realize that value in a way which supports their needs and aspirations. The valuation profession is well equipped to work with other stakeholders (such as governments, municipalities, planners, providers of infrastructure) to provide support for land-based services.

The valuation profession can contribute to a long-term stable solution by ensuring that real estate can be used as collateral; that both property owners and lending institutions are able to benefit from funding which supports community development and aspirations; and by helping to develop active and vibrant property markets in which real estate and be exchanged openly and formally. We need to work with like-minded stakeholders to support such progress and achieve thriving healthy communities – nothing else can be socially sustainable, and the world cannot afford anything less.

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BIOGRAPHICAL NOTES

Dr Frances Plimmer qualified as a Chartered Valuation Surveyor with the Valuation Office in Cardiff after which she joined the University of Glamorgan as a lecturer in 1978. She acquired the degree of Master of Philosophy in 1991, and a PhD in 1999, and was appointed Reader in 1996. She was appointed Research Professor at Kingston University in 2006 and worked at the College of Estate Management as both a researcher and a tutor in valuation until 2011. She is now an Associate Tutor with Cardiff University.

She is a Fellow of RICS, a member of RICS' Research Advisory Board, a member of the Institute of Revenues and Rating Valuation and the Institute of Continuing Professional Development in the UK and the International Association of Assessing Officers in the USA. She is on the editorial advisory board of the *Journal of Property Tax Assessment & Administration* and *International Journal of Housing Markets and Analysis* and was the editor of *Property Management* from 1994 to 2010. Formerly the UK delegate the International Federation of Geometers' (FIG's) Commission 2 (Professional Education), she is now the UK delegate and chair of FIG's Commission 9 (Valuation and Real Estate Management). She has written and presented widely on the subjects of property valuation, property taxation and

compulsory acquisition and compensation, and also on professional education and qualifications.

Dr William McCluskey is presently Reader in Real Estate and Valuation at the University of Ulster. He has held various international positions including Visiting Professor of Real Estate at the University of Lodz, Poland and Professor of Property Studies at Lincoln University, Christchurch, New Zealand, and he is an Associate Tutor with the College of Estate Management. His main professional and academic interests are in the fields of real estate valuation and more specifically ad valorem property tax systems, local government finance, computer assisted mass appraisal modeling and the application of geographic information systems. Within this context he has been involved in a number of international projects advising on ad valorem property tax issues around the world, including Jamaica, Northern Ireland, Bermuda, Poland, Kosovo, Tanzania and South Africa.

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