14 February 2013

Our Ref:  BE/AA/Val.corr

International Valuation Professional Board
41 Moorgate
London
EC2R 6PP

Dear Sirs

Re:  RICS OBSERVATIONS ON THE EXPOSURE DRAFT ON VALUATION UNCERTAINTY

The RICS is pleased to submit the following observations on the exposure draft on valuation uncertainty. It has no objection to this reply being published on the IVSC website.

Questions

1. The proposed TIP defines valuation uncertainty at para 7.

Do you agree with this definition? If not, how do you think that it could be improved?

The definition of Valuation Uncertainty is agreed. We also support associated commentary at paragraph 6 and in particular the clearly made point that a valuation is not a fact but an estimate and opinion made on a stated basis. As such an element of uncertainty is inherent in most market valuations.

However we think the definition of Valuation Uncertainty could be improved upon by tying it in with the amount of subjectivity required; i.e.: “The degree of subjectivity required in the valuation process which varies due to the availability of consistent and relevant data, external factors which are not known, and market perceptions of future events which may or may not be cyclical.” The current TIP ties Valuation Uncertainty to the likelihood that the valuer may be incorrect or proven wrong by a subsequent transaction. This wording undermines the philosophy that a valuation is an opinion, which may not be wrong even if the asset eventually trades for a significantly different price.
2. Various prudential regulatory authorities either have or are contemplating introducing disclosure requirements for assets that are deemed to be subject to “valuation uncertainty” and to apply different risk weightings to these in capital adequacy regulations for banks and other financial institutions. The Board has decided to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance. The reason is that the IVSC is only concerned with proper valuation practice, not with how valuations are then used by the recipient in complying with other standards, laws or regulations.

Do you agree with the Board’s decision to exclude prudential valuation adjustments for valuation uncertainty from the scope of this guidance?

Yes. The central point is to ensure that where there is a material possibility that the reported valuation may differ from the price that could be achieved, it is drawn to the attention of the recipient. This additional information may indeed dictate how the valuations are used but the important point is that attention is drawn.

3. The proposed TIP provides guidance on the distinction between valuation uncertainty as defined in the paper and risk, in particular between market uncertainty and market risk. It was clear from comments received on the Discussion Paper and made elsewhere that the concepts are regularly confused. Some believe that the brief explanation of market risk in paras 16 and 17 is not needed given that the focus of the paper is on uncertainty rather than risk. Others consider that the inclusion of a brief illustration of market risk helps readers understand the distinction between this and market uncertainty.

Which of these views do you support?

We agree with the detailed explanation and illustrations referring to market risk in an effort to explain the differences between market risk and market uncertainty.

The examples provided illustrate the point the well.

However from the perspective of providing valuations of real estate for secured lending we would advise that commentary on the price volatility over time (defined as market risk) or direction of travel of the market should also be provided.

4. The paper identifies three main sources of valuation uncertainty: market uncertainty, model uncertainty and input uncertainty.

Do you agree that these three categories represent the main sources or causes of valuation uncertainty as defined? If not please explain why, and in particular identify any other source of uncertainty that is not mentioned.
For us market uncertainty is the primary source of valuation uncertainty. Unusual liquidity levels are particularly important. Unusual levels of liquidity make interpretation of comparable market transactions difficult - very liquid markets render historic transactions difficult and an absence of trading also contributes to valuation uncertainty. It is this market uncertainty that leads to model uncertainty and input uncertainty. Where the valuation model used has a large number of variables (e.g. DCF and residual appraisals) the inability to find market evidence for the inputs or the output of the model drives the uncertainty.

As such we agree with paragraphs 27 & 28 and would go further in that it is difficult to see how the three sources of uncertainty are not always inter-related.

In respect of "Model Uncertainty" there is an opinion that is really part of the valuation analysis and decision-making by the professional, and there would only be unequal circumstances that would require special notification to the client.

For the purpose of expanding the use of the TIP to asset classes other than financial instruments, we wonder if the term "Input Uncertainty" could perhaps be re-named "Data Uncertainty", which less implies that the valuer is inputting bad or inappropriate information. It also implies that the factors which are uncertain are external, e.g. the inconsistency or lack of relevant data before it reaches the hands of the valuer. Mainly, the term "data uncertainty" better allows for expansion of this topic to other asset classes (e.g. real property) more so than the term "input uncertainty" which implies a valuation based on a computer model; which is perhaps a more effective technique for financial instruments than other asset classes.

5. The proposed guidance indicates that because market uncertainty arises when the impact of events on value is unknown it is identifiable but not measureable. In contrast, model and input uncertainty can be both observable and measureable.

**Do you agree with this position?**

We support the use of sensitivity analysis in presenting valuations that are subject to material uncertainty. By definition the analysis provides a range of values based on variations of the inputs. As such the effect of the varying the inputs in the model can be measurable depending on the circumstances.

Whilst the event causing market uncertainty is identifiable its effect is not definitively measurable. In such cases benefit can be derived via sensitivity or the impact could through the use of special assumptions. For example the threat of the Irish Government to retrospectively ban upwards only rent reviews must have created uncertainty, but the impact of the introduction, or not, of such legislation on the value of a particular property could have been illustrated through special assumptions.
6. The requirement in IVS 103 is to disclose any material uncertainty that affects the valuation. Paras 29-39 of the proposed TIP provide guidance on identifying when uncertainty is material, with reference to the requirement in IFRS 13 for valuations for financial reporting and more general guidance where valuations are for other purposes.

Do you find the guidance on materiality to be helpful? Are there any improvements or other considerations that you would suggest be included?

We consider that paragraphs 29 - 32 are relevant and useful from a secured lending perspective. However some examples of wording which warns the reader of the material uncertainty may also be helpful.

We also feel that it is important to focus on the interrelated nature of valuation inputs – so that, if one is discussing the sensitivity of one input, one also must discuss other inputs that might change as that one input changes – and, when combined, the effect on value is (or is not) material.

7. Para 42 sets out matters that it is recommended be included in a qualitative disclosure of uncertainty.

Do you agree that this identifies the matters that should normally be included in a disclosure of uncertainty? If not please indicate any additional matters that you consider should be included or any matters mentioned that should be excluded.

We agree with the content of paragraph 42 – for secured lending purposes it is very important that attention is drawn to the source of the uncertainty surrounding the valuation, its effect on the market and the valuation process.

Additional guidance on “data uncertainty” could also be added, such as explaining the lack of sufficient transactions in a particular market (thus creating uncertainty in the valuation process), although a market approach was still relevant and normally considered applicable. So the valuer has done more than just explain why a valuation technique was or was not used in the case of “model”, “input” or “data” uncertainty.

8. Para 47 suggests that model and input uncertainty may be more readily measureable for financial instruments than for other types of asset.

Do you have experience of quantitative measures of valuation uncertainty for tangible or intangible assets being disclosed in reports? If so please indicate the types of asset and the techniques used to quantify the uncertainty.
Generally, valuation of asset classes (tangible or intangible) other than financial instruments tends to be more subjective, and this extends to the part where the valuer assesses the uncertainty by way of adjustments to the valuation (e.g. discount or yield rate adjustments). The subjectivity is part and parcel of the “art” of valuation. It would be unusual to have the ability to quantify uncertainty in real property valuation or that of closely held companies, unless there were comparable transactions that were similar in every way except for the factor of uncertainty.

9. Para 51 sets out proposed principles for quantitative measures of uncertainty.

Do you agree with this list? If not please indicate any additional principles that you believe should be included or any listed that you believe are inappropriate.

We agree with the list and principles discussed, but would point out that from a secured lending perspective the use of sensitivity analysis will often be helpful but only if accompanied by a clear narrative as to the cause of the uncertainty and the choice and rationale for the valuation variable on which the sensitivity analysis is based.

10. It is proposed that the final TIP will include a few simple illustrative examples of uncertainty disclosures to assist readers understanding how the guidance may be applied in practice. The Board has decided not to develop these until it has received comments on the principles in this draft. The Annexe to this draft contains an indication of situations for which examples are being considered.

Do you agree with the Board’s proposal to include illustrative examples of typical disclosures? If so, please indicate the situation for which you consider an example would be most useful.

Yes we agree that illustrative examples are a useful idea. We would suggest the example of a simple development appraisal undertaken in the context of a material illiquidity and lack of trading both for development opportunities and finished product in the market place.

The example should include a description of the source of the uncertainty (illiquidity and very low trading volumes) together with a sensitivity analysis showing the effect on value of a number of the model variables. (e.g. hold period, void post completion, exit rent, exit yield etc.)

Below is an example of disclosure:

“The opinions of value expressed in this report are based on estimates and forecasts that are prospective in nature and subject to considerable risk and uncertainty. Events may occur that could cause the performance of the property to differ materially from our estimates, such as changes in the economy, interest rates, capitalization rates, financial strength of tenants, and behavior of investors, lenders, and consumers. Additionally, our opinions and forecasts are
based partly on data obtained from interviews and third party sources, which are not always completely reliable. Although we are of the opinion that our findings are reasonable based on available evidence, we are not responsible for the effects of future occurrences that cannot reasonably be foreseen at this time.”

Yours sincerely

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