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THE EVOLUTION OF VALUATIONS FOR MORTGAGE LENDING PURPOSES

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STRUCTURED ABSTRACT

Problem/Purpose

The valuation of property is undertaken for a variety of purposes of which mortgage lending is the overwhelming purpose. The value determined is dictated by a number of factors including legislative and principle based definitions. This paper examines the valuation of property for mortgage lending purposes, the practices used by valuers, information and evidence relied upon in the valuation process and defines the challenges confronting valuers. It articulates the transfer of risk to valuers as contractors to lenders since the 1990s when valuations ceased being conducted by valuers directly employed by lenders.

Design/methodology/approach

A survey and interviews are used to examine the practices of valuers in undertaking valuations and specifically looks at the cognitive factors which impact the judgement of valuers in selecting the evidence which underpins the value determined.

Findings

The paper demonstrates that elements of automation and improved information may assist in the valuation process, however it is the ultimate judgement of valuers which impact the value determined. It further finds that valuers use alternate methods of valuation in determining value where possible and that in the case of direct comparison method, a unit of comparison is further evolving in supporting the valuation process.

Keywords: Value, valuation purpose, valuer

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INTRODUCTION

In the competitive residential mortgage market there is pressure on the valuer to suggest that the purchase price of property is ultimately the best evidence of value. This paper firstly examines the purpose of the mortgage valuations and why these are required by lending institutions. Secondly, cases have been reviewed that have presumably endorsed this proposition of which an examination of *Inez Investments Pty Ltd v. J.L. Dodd* 1979 NSWSC will define the criteria valuers are to use in establishing whether the purchase price of property is the best evidence of value in undertaking valuations.

The innovation in mortgage lending through the use of mortgage brokers has increased competition particularly in residential housing and investment. With competition has come pressure on the costs of set up and the loan approval process. Among the costs that have attracted the attention of lenders is the valuation fee used to determine the value of the property being purchased or re-financed. In essence, the valuation may be required for two purposes, firstly to confirm if the purchase price of the property being financed is market value and secondly for refinancing purposes, where an existing property is used as collateral or security to raise money.

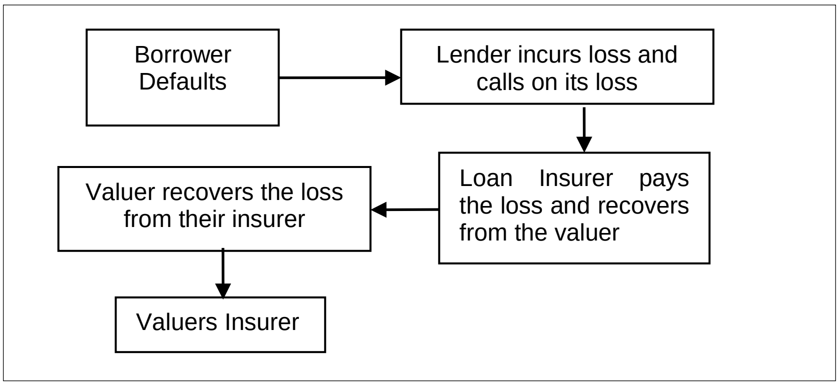
In cases where investors are seeking high levels of gearing on investment property, is it prudent for the valuer to be engaged before commitment to the purchase of the property. The use of valuations may be questioned on the basis that mortgage insurance may be taken out to insure the lender against default by the borrower. On this basis then it must be questioned as to why a valuation is necessary when lenders will cover themselves against default, by having the borrower pay for mortgage insurance in the case of lending on highly geared loans. What becomes apparent through this paper, is that valuers and valuations are in fact part of the insurance and reinsurance process used to protect the lender.

WHY ARE VALUATION'S NECESSARY?

The initial answer that addresses the purpose of valuations undertaken by lenders is for the protection of the lender and the deposit money held by the lender, "All assets taken as security by (ADI's) should be valued, wherever possible, at their net current market value" (Australian Prudential Regulation Authority, 2000:1). Following the deregulation of lending during the 1990s, In the case of mortgage valuation work, many of the employees of lending institutions set up practice and began contracting valuation services back to lenders. This process was seen as a way of creating market efficiency in the cost of valuation services, in addition to the perceived benefits of creating a regulator and operator relationship. Grosvenor (2000) highlights the impact of outsourcing valuation work, which will lead to the long term shortage of qualified valuers with field experience. This is largely attributed to the reduction in the training of valuers by government departments and lending institutions who have traditionally undertaken this role by employing valuers directly.

The change in status from employee to contractor necessitates the contractor carry professional indemnity insurance to protect themselves against any litigation and liability that might be brought against them by their instructing party, namely the lender. This may also include any action brought against the lender by the borrower as a result of the valuation advice provided to the lender by the valuer. In reality, the valuation provided by the valuer to the lender constitutes an insurance policy, which effectively allows the mortgage insurer to insure the loan and cover the lenders loss and recover any loss from the valuer under their right of subrogation. In effect, the valuer's professional indemnity insurance policy is a reinsurance policy in the lending process as set out in Diagram 1:

Diagram 1 - Chain of Claims



An interesting disclosure made by the Australian Prudential Regulation Authority APRA (2005) in **Survey Results – Residential valuation practices by ADI's and LMI's** of May 2005, shows that of the eight Lending Mortgage Insurers (LMI's) six are owned by Authorised Deposit Institutions (ADI's). In effect, lending institutions, who are bagged as authorised deposit taking institutions in this survey are also in the mortgage insurance business. The reality is that the valuer's insurance acts as a filter in the reinsurance process of spreading the risks through their insurance and is demonstrated in Table 1:

The disproportionate cost of mortgage insurance compared to the valuation fee for lending purposes where the LVR is greater than 80% highlights that the valuation profession may not fully recognise the role, responsibility and risk in the provision of mortgage valuation work for high LVR work. This is particularly pertinent as shown in Table 1 in the last example, where the valuation fee represents 3.3 percent of the mortgage insurance cover which are both paid by the borrower. This difference is even more pertinent when consideration is given to the fact that eight Lending Mortgage Insurers (LMI's) six are owned by Authorised Deposit Institutions (ADI's).

Table 1: Relativity of Mortgage Insurance and Valuation Fees

Property Value	**Loan Amt as % of property value**	**Mortgage Insurance**	**Valuation Fee**	**Valuation as a % of Insurance**
$500,000	80%	N/a	$25	
$500,000	81%	$2246	$220	10
$500,000	85%	$4505	$220	5
$500,000	90%	$6660	$220	3.3

Source: Big four banks mortgage insurance

In contrast to the total number of property's valued, the number of cases that lead to litigation against the valuer are nominal. What is not taken into account are cases where property has been purchased or refinanced supported by a mortgage valuation which have not been tested by the sale or subsequent resale of the subject property. An analysis of claims against valuers may fall into two broad categories, those brought about by economic circumstances, particularly where the market has fallen subsequent to the date of valuation which was at the height of an economic period, these are referred to as 'waves' of claims (Connell 1990). The second category being those described as routine or 'static element' cases, (Lavers & Spurges 2002).

Following the global financial crisis it was found that In contrast to the United States, the exposure to low doc loans in Australia was lower, the Reserve Bank of Australia (2007) highlights that as at June 2007, prior to the beginning of the Global Financial Crises (GFC), exposure to loc doc loans within Australia was 7 percent less than half of that in the United States. A combination of Australia's strict lending guidelines and the adherence to the use of valuations in the property purchase process results in Australia's banking system ranking among world's best practice (Senate Economics Reference Committee 2011). A factor impacting this ranking is attributed to the robustness of the requirements for valuations in the lending process (APRA 2005).

While valuations have traditionally been used by lenders in Australia the traditional use of valuations for mortgage lending purposes are commissioned by the lender after the agreed price of the property has been determined. This results in the valuers coming under pressure to write the purchase price of property as its value, "Recent experience has shown that current major mortgage lending institutions are applying great pressure for valuers to place emphasis on the subject sale" (Rooke 2002:48). In contrast to the pre deregulation of the banking industry in 1992 when valuers were directly employed by the banks, Mangioni (2006) highlights that valuers are beginning to be engaged by lenders under contract to confirm the purchase price of property as its value for the lowest possible fee.

THE VALUATION PROCESS: HOW IS VALUE DETERMINED

The determination of value has a long standing history as defined in Spencer v. The Commonwealth 1907. The formulation of 'market value' and deriving of the value of property is largely predicated on evidence that supports the market value assigned by the valuer. Without evidence, the valuer's opinion is no better informed than another opinion of value. This is highlighted in Reading v. The Valuer General (1923), 6 L.G.R. 132 in which Pike, J. stated:

> Every expert is entitled, if he sees fit, to ascertain the market value –to rest on his own opinion apart entirely from any market transactions, but if he does so he is liable to be met by three things:
>
> a. The opinions of other people.
> b. Values based on sales; and
> c. Any previous opinion that he himself might have expressed as regard to values.
>
> Mr….., like all of us, was not born with an opinion of land values (Rost & Collins 1984:86).

In mortgage lending valuations, valuers are provided with the property purchase details and asked to confirm the purchase price as value, however Rooke (2002:48) states that "Recent experience has shown that current major mortgage lending institutions are applying great pressure for valuers to place greater emphasis on the subject sale". For some valuers this process has a profound impact on the result, Gallimore in Black *et al*. (2003) found that valuers may inappropriately give greatest weight to the most recently considered information. Further, it is suggested that expert valuers indicated that they make early, preliminary judgements and then seek evidence in support of these opinions.

In contrast to this phenomenon in some circumstances it is difficult for the valuer to determine the value of the subject property due to a lack of sales evidence. This is further compounded when the valuation being sought is for refinancing purposes and there is no sale over the subject property being valued. In these cases, the duty on the valuer is not lessened. It is the role of the valuer to look geographically further or outside the radius of sales that a valuer would ordinarily look at, as well as further back in time for sales within the locality of the property being valued, *Griffith Producers Co-Operative Society Ltd. v The Water Conversations and Irrigation Commission (1926) 5 L.V.R. 190*.

In some cases sales are scarce and in other cases there are issues of access to sales information and the speed in which sales information becomes available from the date of exchange of contracts to settlement and the eventual recording of the transaction in land information systems. This in part has led to criticisms of the valuation profession as Hunt (1998:106) states, the issue of outdated sales information and the timeliness of valuers obtaining sales data, is said to attribute to valuers determining "where the market was rather than where the market is. This leads to criticism of 'over-valuation' in falling markets and 'conservatism' in rising markets". Wyman, Seldin and Morzala (2011) further define the problem that there is rarely enough data and the data in property transactions is available is not normally distributed so basic statistical models and probability analysis are not necessarily appropriate.

This issue has been considered by the Reserve Bank of Australia (2004) which considered the alternatives of agents reporting the sale price of property once a contract price is agreed, or lenders providing information once they have agreed to provide funds for purchase as further proof of market evidence in progress. From a valuation process, while much focus has centred on the methods of valuation, of which direct comparison is deemed the most common and best understood, the complexity is no less complex to other methods of valuation in the absence of comparable sales (Pagourtzi, Assimakopoulos, Hatzichristos and French (2003).

The complexity in undertaking the valuation extend to encompass a number of factors for which some level of adjustment is made between sales and the subject property. In contrast to the comparability of the property in the sale analysis process, Hunt (1998) looks at the comparability of the sale which encompasses additional information including, the special conditions of the sale, vendor/purchaser/agent motive, method of sale, marketing period and market dynamics. Waldo and Clarke (2010) further add to the complexity of analysing sales resulting from changes in economic circumstances between the last relevant sale and the date of valuation.

The importance of sales evidence and analysis in undertaking valuations and the subsequent proving or disproving of values cannot be understated. The process of sales analysis further involves questioning buyer behaviour and the valuers ability to interpret this when valuing property using comparable sales. This is the step that follows on from the selection of the sales sample to be analysed. Part of the sales analysis process is the adjustment of sales by valuers through interpreting buyer behaviour (Daly *et al* 2003). A preliminary requisite in the sales analysis process is the selection of the most suitable sales. This may be difficult as determining the most suitable sales, may require an element of buyer behaviour analysis.

In summary, the sales analysis process is imperative in the case of valuations used for mortgage lending purposes, given that once the sale is complete and deemed to have met the Spencer Test, is then written into history, on which other property being valued is relied upon by the valuer undertaking the same task. In the case of *Inez Investments Pty Ltd v. J.L. Dodd* 1979 NSWSC, the valuer undertaking the valuation of the subject property was successfully litigated on the basis that he did not examine the sale of the subject property as part of the evidence in determining the value of the property itself. Rather than omit the sale of the subject, the valuer must also examine the subject sale to ensure it satisfies the Spencer test. Once it has been determined that it does meet this test the sale of the subject property does form for part of the evidence of value of the transaction itself.

What appears to have happened over time is that a select interpretation from Inez v Dodd (1979) has become the mantra of some mortgage lenders to assert that the sale of the subject property is the best evidence of its value. This is incorrect and it is an important point for valuers to understand what in fact was stated by the court in this case follows:

> I conclude therefore that a prime matter for investigation when a valuation is sought is to ascertain whether there is current a contract for sale of the property and, if so, to make an analysis of that sale to see how it complies with the test of value as laid down in Spencer's case. Failure to carryout these functions is to risk ignoring the best evidence of value (Carmichael J 1979:11).

This paragraph sets out a clear directive for the valuer to follow in determining whether the sale price of the subject property is its market value. This is so when the sale of the subject property may become a more important component of the evidence to be considered when valuing property for mortgage purposes, particularly in the absence of comparable sales evidence. The clear directive covered in this paragraph being ***"make an analysis of that sale to see how it complies with the test of value as laid down in Spencer's case"***. On this basis, the sale of the subject property cannot be ignored and forms part of the evidence of value once passing the Spencer Test.

In contrast to the total number of property's valued, the number of cases that lead to litigation against the valuer are nominal. What is not taken into account are cases where property has been purchased or refinanced supported by a mortgage valuation which have not been tested by the sale or subsequent resale of the subject property. An analysis of claims against valuers may fall into two broad categories, those brought about by economic circumstances, particularly where the market has fallen subsequent to the date of valuation which was at the height of an economic period, these are referred to as 'waves' of claims (Connell 1990). The second category being those described as routine or 'static element' cases, (Lavers & Spurges 2002). In each of these circumstances, the basis of proof lay in the sales evidence that either supports or refutes the valuation.

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Research Method

In reviewing the practices of valuers in the analysis of sales and valuation process, a survey of valuers undertaking valuation work followed by interviews of the results with a select number of valuation principals was conducted. Fowler (2009) defines the key objectives of surveys are to produce quantitative or numerical descriptions about the study population. In the study, the principal valuer's of seven valuation firms in

Sydney and Regional NSW were first contacted and surveys distributed to valuers to establish the practices of valuers on the valuation of residential property. Surveys were distributed to 110 valuers across Sydney and New South Wales by post, with 43 surveys returned representing a response rate of 39 percent. The results of these surveys follow, with discussion at the conclusion of the responses. The following eight questions address purpose, risk, evidence and information sources that valuers rely on in undertaking valuations for mortgage lending. The survey and responses are set out in the format of question, summary of response and discussion for each of the questions, some questions are grouped where the nature of the questions supplement each other.

Question 1
List the three main purposes for which you undertake residential valuations in by reference to the number of valuations in the following purposes?

Responses

Purpose	Valuer responses
Mortgage	38
Transfer / Capital Gains Tax	22
Family Court	16
Buy or sell advice	14
Objections & Acquisitions	4

Discussion

Mortgage valuations are by far the dominant purpose for which valuers are engaged, followed by transfer which are used for the assessment of stamp duty or conversely capital gains tax. Banks and lending institutions are the instructing parties engaging the valuers who are first admitted to the lenders panel of valuers. Family court and providing buying and selling advise followed ranked in third and fourth position. It was highlighted by principals that in some cases there are two purposes included within the same valuation. In the case of family court matters, it may well be that the value is used for settlement between the parties, which doubles as buying and selling advice where there is no disagreement on the value. It may also in addition be used for transfer duty in the assessment of stamp duty where applicable.

Question 2
On a risk rating of 1 to 10, with 1 being the lowest risk and 10 being the highest risk, what risk rating do you assign to a valuation undertaken on a residential property based on the following four valuation cases:

Responses

Valuation sub-purpose	Median Risk Rating	Average Risk Rating
Sale over the subject property plus several current comparable sales	2	2.3
Refinancing of a property and no sale over the subject but several comparable sales	3.5	3.4
A sale of the subject property and no comparable sales evidence	5	5.4
Refinance with no sale over the subject property and no comparable sales	7.5	7.6

Question 3
What is the minimum number of sales you would use to determine the value of a property?

Responses

Minimum sales	Number of valuers	Median years experience
3	11	10
4	15	20
5	8	10
6 or more	7	30

Discussion

Questions 2 and 3 are related as they assess risk which is impacted by the both the sub-purpose and the evidence of value. The overarching purpose is mortgage lending of which the sub-purpose is confirming the purchase price as value versus lending for refinancing purposes where there is no sale over the property. In the case of valuations used to confirm the purchase price, valuers had mixed views on whether the sale of the subject property formed part of the evidence of its value. This was largely determined by the results from Question 3, to which many valuers did not consider the sale of the subject property where there was an abundance of evidence and the purchase price paid was supported by that evidence.

Valuers suggested that a preferred minimum number of sales needed to support the valuation was three, however as was highlighted where an outlier sale existed among the three sales, four was the most preferred or common number of sales valuers sought. It was highlighted in discussions, that n a number of occasions there is little or no evidence of value by reference to truly comparable sales. In these cases, valuers did scrutinise the sale of the subject property to a greater degree. In the case of valuations for refinancing where there was not sale over the subject property, valuers were more cautious as reflected in the risk rating assigned.

As noted in the second and third sub-purpose valuers rated a higher risk against a sale over the subject property, with no comparable sales which further supports the view that valuers rate independent sales evidence over and above the sale of the subject, where the sale of the subject meets the Spencer test. It was highlighted the valuers in discussion that most of the litigation cases against valuers result from valuations for refinancing purposes in contrast to valuations confirming the purchase price as value.

Question 4

In cases where you have determined the value of a property for mortgage lending purposes at a figure lower than the purchase price, how frequently are you contacted by the lender.

Responses

	Per cent
Median	95
Average	85.7

Discussion

In almost all cases valuers where valuations are sought to confirm the purchase price as value, valuers are contacted by lenders in the case of valuations which are lower than the purchase price. In the few exceptions of cases where valuers are not contacted, results from sales evidence clearly reflects that the purchase price is high and the valuer is experienced and has several years of experience working for that lender. It was highlighted however in some cases where the purchaser has existing loans and collateral with the lender, the valuer may not be contacted on rare occasions. I was also highlighted by valuers that many lenders will verbally advise the purchaser or refinancer of the value determined, however reserve the right not to pass the actual valuation on to the purchase or property owner in refinancing cases.

Question 5

What are the main sources of sales data used in undertaking residential valuations?

Responses

Source	No of valuers	Percentage of valuers
RP Data	25	58
Agents	6	14
Red Square	6	14
Aust Prop Monitors	3	7
Realestate.com	2	4.7
Other	1	2.3
Total	**43**	**100%**

Question 6

When analysing residential unit sales, what percentage do you know the number of bedrooms and area of the property:

Responses

	Median Per cent	Average Per cent
No of bedrooms	80	72
Area of the unit	50	40.7

Question 7

Is property transaction information available in an acceptable timeframe?

Response

	Yes	No
No of responses	11	32
Percentage	25.6	74.4

Discussion

Information sources, level and timing of information is an important factor in the delivery and quality of valuation advice. This is particularly the case in mortgage lending where market condition change within months of sales evidence transaction. Valuers have overwhelmingly stated that RP Data is the most common source of information followed by real estate agents and Red Square as a distant second place. Valuers added that the recording of some sales information prior to settlement within RP Data has improved the timeliness of information relied on, however overall only 26 per cent of valuers stated that sales information was delivered in an acceptable timeframe.

In terms of the description of property information valuers stated that in 80 per cent of time they were aware of the number of bedrooms within each sale, however only 50 per cent of valuers knew the building area of the sales. The valuers highlighted that size of improvements, orientation of the living areas and floorplan were important factors which contributed to value and would be of further benefit in the information made available.

Conclusion

This paper demonstrates that over the past two decades the role of the valuer in mortgage valuation work through outsourcing has moved the risk from the lender to the valuer. This is particularly the case for highly geared loans of which the borrower pays mortgage insurance to protect the lender while valuations are part of the reinsurance process in the chain of claims to recover any value related losses by the lender. The role of determining value is underpinned by sales evidence and the timely and sufficiently detailed availability of data to valuers. The role of the valuer is to further qualify that data and use it to confirm that the sale of the subject property once the sale of the subject property passes the Spencer Test. The sale of the subject is either the best evidence of value, or greatly contributes to confirming that fact once the valuer has undertaken an analysis of the subject sale.

A distinction is made between valuations for mortgage lending where a sale over the subject property exists, versus valuations for refinancing purposes and it was highlighted that litigation against valuers largely results in refinancing cases with limited sales evidence. This further strengthens the fact that a sale over the subject property contributes to evidence of value once the sale has been examined and that valuers are to undertake that analysis as part of the valuation process. The survey conducted examines the practices adopted by valuers and confirms that most of the sales data used by valuers is provided by one primary source and is progressively being made more readily available. Valuations for mortgage lending purposes are the dominant valuation purpose in Sydney and NSW. The detail of information which valuers rely upon varies across such factors as the building area, number of bedrooms and floor plan, however the consistency of these specific details is limited.

It is highlighted in the literature and confirmed in the survey that valuers seek a certain number of sales to determine value, of which four sales is the most common number needed to undertake the valuation process. In some cases however sales evidence is scarce and in these cases where there is no sale over the subject property being valued, a tendency exists for valuer to determine value at the conservative end of the market value range. In conclusion, valuations for mortgage lending underpin the lending process and have traditionally protected the lender and adding to the robustness of the banking and lending system in Australia.

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