

Managing Risks in Property Exposure via Valuations/Appraisal Assessment

Simon ADCOCK, Australia

Key words:

ABSTRACT

Western world governments and private business have developed sophisticated risk management systems that aim to identify risk and formulate mitigation strategies. This creates an environment that promotes greater certainty and profitability for these organisations to operate in the global marketplace.

As part of this process, global organisations have begun to standardise practices to ensure consistency across their world-wide operations. Apart from operational efficiency gains, this provides them with heightened risk management via a consistent approach to risk assessment and its treatment.

The development of a system for “**grading the level of risk**” across defined property types will lead to greater certainty of property value when valuation assessments are undertaken. Enhanced risk management grading will enable global investors to more confidently assess the exposure and risk levels associated with property types and in turn, the likelihood of fluctuations in property value over time.

I have used the experience of Valuer-General Victoria throughout my presentation as a case study as it demonstrates some of the sophisticated risk management styles that have been developed. However, before outlining these methods, it is important to firstly define risk and exposure.

CONTACT

Mr Simon Adcock, Manager, Client Valuations
Valuer General Victoria
Land Victoria
Department of Natural Resources & Environment
Marland House, Bourke Street
Melbourne 3001
AUSTRALIA
Tel. (Mobile) + 61 411 016 603
E-mail: simon.adcock@nre.vic.gov.au

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1. INTRODUCTION

Western world governments and private business have developed sophisticated risk management systems that aim to identify risk and formulate mitigation strategies. This creates an environment that promotes greater certainty and profitability for these organisations to operate in the global marketplace.

As part of this process, global organisations have begun to standardise practices to ensure consistency across their world-wide operations. Apart from operational efficiency gains, this provides them with heightened risk management via a consistent approach to risk assessment and its treatment.

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2. WHAT IS RISK AND EXPOSURE?

These represent the fundamental purpose for both managing and obtaining a valuation/appraisal assessment.

2.1 Risk

Risk represents *the potential for loss and/or damage*. Some risk we will be aware of and some we will not. It can be further articulated in terms of its degree of certainty of outcomes across the full range of Business or Government operations and their type of risk. For example these can include operational, financial, reputational, or in the case of a Government organisation, political.

2.2 Exposure

Whereas risk refers to the particular event and the probability of its occurrence, exposure is defined as the magnitude of the potential consequences. For example, in addressing the potential for damage from bush fire in a particular area, risk refers to the likelihood of the bush fire occurring, while exposure refers to amount of property which could be damaged as a result of such an occurrence. The diagram below illustrates this simple concept of how each property category is exposed to the risk of bush fire.

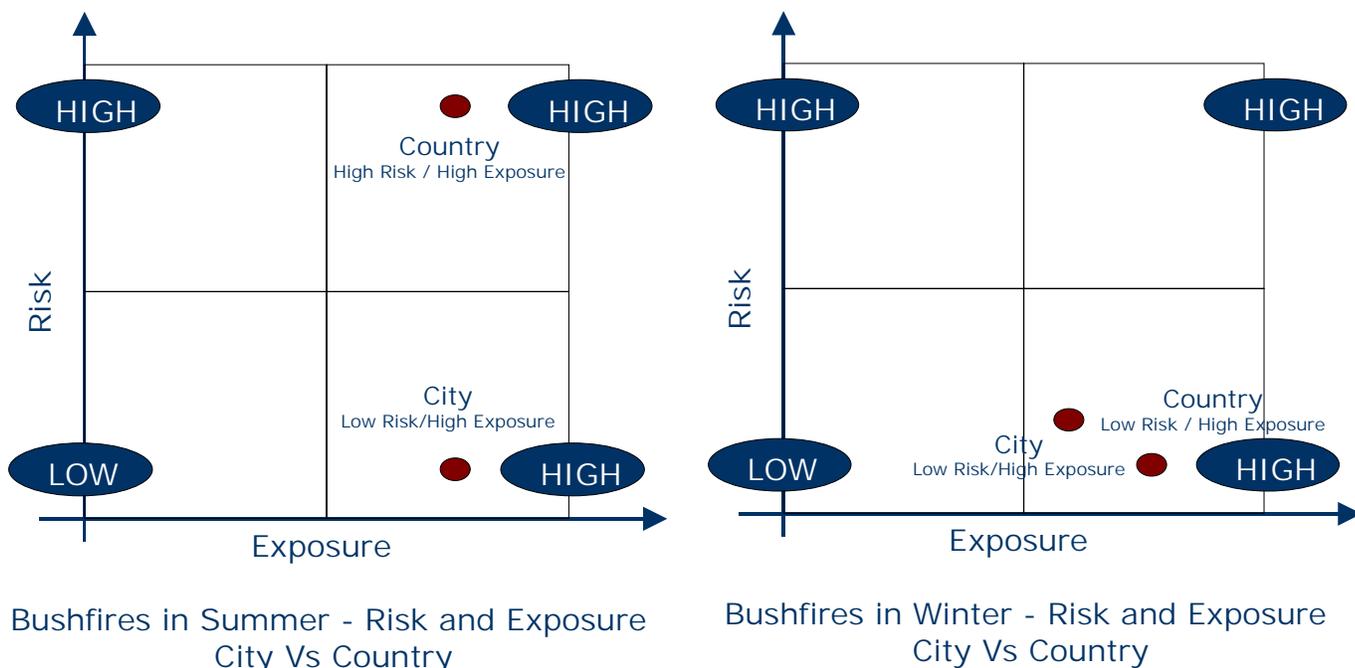
In city areas during summer, the risk of fire is relatively low (good fire services availability, no real change to the availability or nature of material to burn), yet the consequences of a fire in a city locality is always relatively high.

Conversely, in the country where there are large quantities of dry trees and grass available combine with the remoteness of fire services to combat or prevent the fire, the risk and exposure and consequences are both very high.

In winter, the diagram would change. Taking away the “tinder box factors”, the risk is substantially lower along with the exposure. Insurance companies have been applying risk assessment for years.

So we want to identify risk and minimise the exposure.

Table 1 – Risk and Exposure



3. RISK MANAGEMENT STRATEGIES

Many international organisations have identified the need to develop sophisticated risk management strategies to essentially provide a coherent approach to Business Process Operations (BPO). This includes valuation/appraisal tasks that are undertaken.

Exposure, which also incorporates issues within the political realm, can be substantially minimised by adopting procedures that are transparent and independent for providing quality, independent valuation/appraisal advice – all of which contributes to excellence in governance, management and administration.

3.1 Firewall Unit (FWU)

Many global organisations have already developed either internal or external/procurement Business Process Units (BPOs) to transfer some of the risk and provide an independent and transparent approach.

Such specialty units offer a protection between the User of valuations, for example a bank, and the professional who is undertaking the valuation assignment. These FWU's are often equipped with highly skilled professional valuers who are capable of understanding the precise issues of the valuation from the perspective of both the User and Valuer.

They offer an invaluable service to both of these groups in managing the whole valuation process.

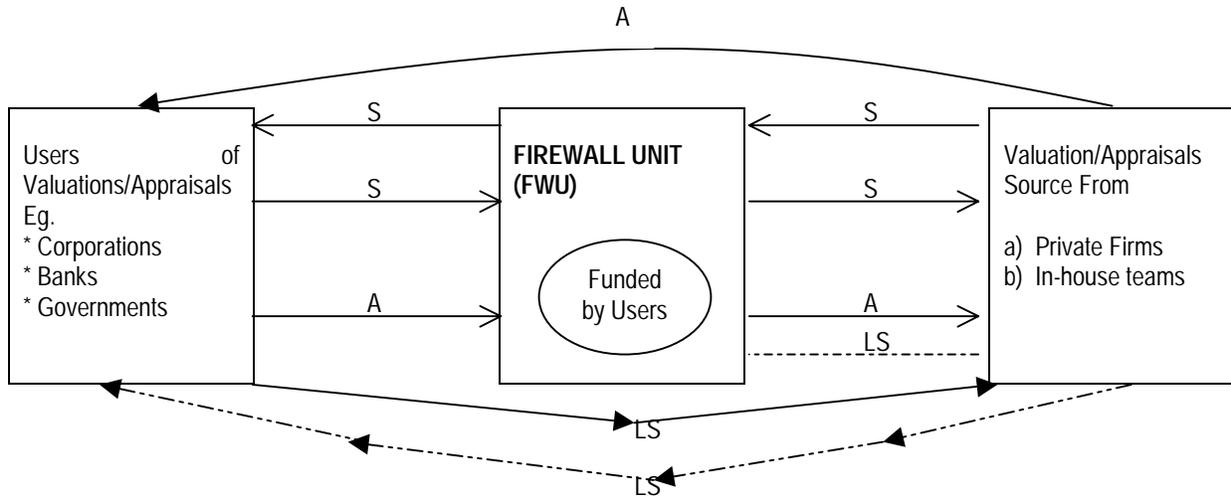
The 'Certification' letter that the User ultimately receives, offers a heightened system of checks and balances and confirms that a Professional, with extensive valuation/appraisal skills from the FWU, has scrutinised the report and its accompanying/supporting information.

Furthermore, it confirms that the FWU Manager *agrees with the methodology*, contents and processes that have been used in formulating the outcome.

The Certification confirms that the required processes have been undertaken to the FWU's expected standards and that the conclusion reached is verifiable. It does not mean that the FWU certifies the end figure but that all the current procedures were undertaken in achieving a verifiable, accurate process in achieving an outcome.

For the Victorian Government, an important role of Valuer-General Victoria (VGV) is the establishment and management of three separate levels of Panel Membership. These comprise external, private sector firms who are available and accredited to provide professional valuation services to Government in accordance with VGV's quality procedures (ISO 9002:1994 Certificate n. 10022).

Table 2 – Flows of Alternative Risk Management Strategies



Alternative Flows of Risk Management Strategies

STEPS

S High, Significant, Medium Sensitivity Tasks/Projects

A Second/Check valuation managed with Independent Reporting

LS Low Sensitivity Tasks/Projects

Table 3 – Certification Flow

SENSITIVITY LEVEL	CERTIFICATION	PROCESS
High Sensitivity	Certified	In-house team managed by Firewall Unit
Significant Sensitivity	Certified	In-house team or extensive project manager (by Firewall Unit) procurement Valuation/appraisal from Panel
Medium Sensitivity	Certified	Firewall Unit instructs Panel
Low Sensitivity	Not Certified	User instructs Panel member direct

The effective and efficient use of the three Panels is dependent on the appropriate selection process. This commences with the identification/classification of the valuation task through to the valuation type and the purpose upon which that valuation assessment is to be applied.

Together, these key items provide the *sensitivity framework* before consideration of the *sensitivity drivers*.

3.2 Sensitivity Drivers

These drivers are very similar in both private and public sector organisations. Most western governments aim to operate with the same efficiency and best practice processes as major private sector corporations.

3.2.1. High Sensitivity Drivers (HSD)

There are two sub-groups that form the HSD. These are 'High' and 'Significant' and are treated with different control processes.

3.2.1.1.High Sensitivity (HS)

For "High" sensitivity, an in-house valuation from the valuation team will be provided and certified by the Head of the Firewall Unit.

Particular drivers include:

- **Parliamentary/Corporate Board Enquiry**
A Minister or Corporate Board member could, for instance, be asked a question in Parliament or at a Shareholders meeting about the value or sale of land owned by that entity. The Minister or Corporate Board member may request a valuation/appraisal from the Head of the Firewall Unit, and this would be completed by the in-house valuation team.
- **Ministerial/Company security/absolute transparency of process required**
A request from a Minister/Corporate Board member regarding a transaction involving land that is of political, community or cultural significance and is at a stage in the process where confidentiality is essential.
- **Market Confidentiality**
Valuation/appraisal in relation to some government/corporate property transactions need to remain confidential to prevent market operators and/or competitors being inappropriately placed in a privileged situation.
- **Preliminary Program Assessment**
Provide valuation/appraisal advice for major government/corporate initiatives. Depending on the corporate structures involved the following could constitute as highest sensitivity drivers:
 - Policy Development
 - Dispute settlement
 - Property uniqueness
 - Lack of market evidence/methodology.

3.2.1.2 Significant Sensitivity Drivers (SSD)

For Significant Sensitivity Drivers, an in-house valuation/appraisal from the valuation team is provided. Alternatively the valuation may be outsourced/externally processed but is closely project managed by the Firewall Unit. The valuation/appraisal is certified. Particular drivers will include:

- **Program size**
The size of the valuation/appraisal request may require the tasks to be outsourced or externally processed. For example, plant, equipment and land assets.
- **Public/Private Interest**
This also relates to the program size. Large valuation/appraisal requests would be outsourced, but if there is an element public or private related company interest in the land, the process would also be closely managed by the FWU.
- **Government to Government or company to related company**
If a number of Government agencies or related companies are included in a land sale or purchase, then the FWU should coordinate the valuation/appraisal assignment.
- “\$” value is usually not a determining factor although generally the more a property is worth, the higher the sensitivity is in providing a valuation/appraisal. Nevertheless some land may be of a lower dollar value but still constitutes high sensitivity. For example, there may be community or heritage issues associated with the site.
- **Substantial “\$” amount**
This is where the value exceeds a certain level pre-determined by the FWU and/or the “User” (in the case of State Government of Victoria the amount is \$500,000). A second valuation/appraisal managed by the FWU, and independently reported to the “User” is undertaken in this situation.
- **Others**
Others, depending on the corporate structure, could include inspection of market values, outsourced property function and the compulsory acquisition of land by Government.

3.3 Medium Sensitivity Drivers (MSD)

The valuation/appraisal will be completed by FWU Panel (in the case of Victorian Government – this is the Valuer-General Victoria) and is certified by the unit. The particular drivers include:

3.4 Market information readily available

There is a lesser need for the direct involvement of the FWU when market information is readily available.

3.5 High Volume Program

Where there are many valuations/appraisals involved, the level of confidentiality is not as high and there is only low profile interest.

– **“\$” value not a determining factor**

Property value (in the case of State Government of Victoria more than \$250,000) requires certification over a certain threshold. This, however, will vary depending on the country and judgement of the establishment group for the BPO. In some cases, land worth less than this amount may still require certification because of sensitivity (refer previous discussion).

3.6 Low Sensitivity Drivers (LSD)

The valuation/appraisal will be completed by the Whole of Government/Corporate Panel and no certification will be provided by the FWU. The particular drivers include:

3.7 Minimal Impact on the Overall Management of Government/Corporate Property

The project is deemed to have little effect in Government/Corporate land management. For example, the sale or rent of small land parcels.

3.8 Low “\$” Value Subject to Policy

Where the Government or corporation has deemed an amount to be “low” it does not require certification and can proceed to “Whole of Government/Corporate Panel”. However, if other sensitivity drivers are high, the task would be elevated to the appropriate level. For example, it would be referred to the MSD.

3.8.1. Firewall Unit Process for High sensitivity

These would be valuation tasks that require extensive expertise and may be performed by an in-house valuation team member or extensively project managed by a specialist manager. Such valuations would involve a high level of certification with substantial justification.

High level of sensitivity and complexity, coupled with the level of value involved, can often result in an additional valuation/appraisal/opinion being sought by the FWU. This would be independently reported back to the User thus providing them with two opinions - one certified by the FWU and the other independently managed by the FWU. Should the opinions vary substantially (generally determined at greater than 10 % or an alternative method), the valuation/appraisal firms would present their views and the FWU would determine an appropriate level and then report the outcome or advice. This would become the *opinion* to be relied upon by the User in their decision making.

A prime example would be the assessment of a multi purpose development site capable of taking a mixture of residential, commercial and retail development. This valuation task can produce a range of views/opinions regarding the effect on the level of value between professionals. Conferences or mediation are often required under this scenario.

3.8.2. Firewall Unit Process for Medium sensitivity

In these cases the FWU would be involved in the selection of the appropriate valuation/appraisal firm and in many cases this may include the selection of the individual valuer within the firm. This provides an independent, transparent role for the benefit of both the User and the Professional who is managing the process. Furthermore, the valuation would be certified by the FWU that the valuation/appraisal task has been completed to a level that is independent and that a satisfactory methodology has been utilised. The level of value is thus capable of scrutiny and can be relied upon as a quality valuation.

An example would be a small commercial development site in an urban area where both the level of value and the sale of the asset would have an impact upon both the market and the parties involved. Another example is where an organisation was intending to purchase or lend funds on a number of houses across a regional urban area. In this case, the flow-on benefits of independent valuation/appraisal advice for the organisation is paramount.

3.8.3. Firewall Unit Process for Low Sensitivity

These tend to be categorised as properties that are of a relatively low value and are not part of a major program or acquisition with flow-on effects. Good examples of these would be an individual house in an outer urban or rural area or an individual house block of land in an urban area.

In these cases it would be reasonable for the User of the valuation to select from an approved list of valuation/appraisal firms managed by the "FWU" and proceed to obtain the valuation.

An annual audit process of these firms to ensure that they are providing an appropriate quality of service and are maintaining professional standards is an important feature of managing low sensitive low valuation/appraisal tasks.

In view of the distant relationship that Valuer General Victoria would have in the process, valuations are not individually certified. In terms of the level of risk, the consequences of the outcome would have relatively minimal impact on the overall management of the organisation's property portfolio.

3.9 VALUATION TASK ASSESSMENT

Today the concept of one valuation/appraisal report for all types of property is seen as inappropriate in an efficient business-focussed environment. The level of sensitivity drives both the extent of FWU and the type and style and valuation/appraisal reporting.

3.9.1. Performing High Sensitivity Valuation Assessment

The degree of detail in this report would be extensive. It would cover the methodology and the various approaches that have been taken by the Valuer to establish the level of value. It would show the Valuer's level of discussion and their thinking processes in the

valuation/appraisal task. I would also expect to see the weighting of arguments, sensitivity analysis and even some regression analysis. This results in the valuation/appraisal conclusion being comprehensive.

Such a comprehensive valuation/appraisal report would be articulated in a manner that it becomes what is known as a speaking valuation. It has the foundation of both case law and supported by facts and figures.

3.9.2. Performing Medium Sensitivity Valuation Assessment

The reporting style, say for a row of strip shops, would require a further level of explanation including a description of the property, analysis of the commercial levels of rental and the area of capitalisation approach that was taken. It would enable the FWU to understand and follow the analysis to a level which satisfies it that all items have been covered and both the level of value and the approach as justifiable.

3.9.3. Perform Low Sensitivity Valuation Assessment

A proforma style report containing selected items and minimal sale analysis is often a suitable and acceptable approach for low sensitive valuations/appraisals. An example of this report style would be identifying the external cladding of a house. Here the Valuer can “tick off” a proforma assessment from the type of material, for example, brick, timber or cement sheeting. Furthermore, this report may identify comparable sales evidence in a simple analysis format. The level of sensitivity and reporting has thus been directly related to each.

4. BENEFITS OF RISK MANAGEMENT

Each of these benefits should be of a relevance to all levels of management but particularly to senior management, Chief Executive Officers, Board Members and Ministers of Government.

4.1 Cost Effectiveness

Economic reality means that there will never be enough resources to eliminate every hazard in the valuation industry. Controlling all identified risk is impossible. This is based upon prevention rather than reaction.

It requires an attitude of change including concentrating on the results of incidents to exercising a degree of foresight about potential risk to enable counter measures to be taken/implemented.

4.2 Unbiased Risk/benefit Decision–Making

The idea of risk arising unexpectedly to surprise and paralyse the organisation becomes virtually obsolete with an effective risk management process in place. For example a Firewall Unit where the result along with all assumptions, guesses and other intuitive ideas about the potential risk may be discussed and simultaneously assessed.

Risk will be minimised in this environment.

4.3 Business Process Operations

As organisation's search to devise greater efficiencies and deliver consistent services across borders, particularly in the field of exposure to property risk, a sophisticated protection methodology and approach/procedure is essential.

5. TREATMENT OF RISK

Obtaining a valuation/appraisal is an acceptable method of treating risk for buyers, sellers and lenders. As an industry, we should be promoting this treatment of risk!

5.1 Risk Transfer

When an organisation obtains a valuation/appraisal it is effectively transferring some of the responsibility or burden for a loss to another party through legislative/contractual arrangements, insurance or other means.

For example, a Bank receives a valuation/appraisal for a development upon which it may lend money to the prospective developer. The key reason the Bank seeks such a valuation is to determine the open market value, the potential exposure and the required level of insurance coverage. It thus *minimises its risk* of its interest (as lender) in the development.

The risk is partly transferred to the Professional undertaking the valuation assessment. The professional should also have professional indemnity insurance.

5.2 Risk Reduction

Appropriate techniques and management principals are selectively applied to reduce either the likelihood or consequences (or both) of identified risks. The establishment of a FWU independent of both the organisation and the Professional who is producing the valuation/appraisal is a highly effective risk management tool.

6. ANALYSIS AND ASSESSMENT AND LIKELIHOOD AND CONSEQUENCES OF RISK

The application of the Analysis/Assessment-Likelihood in accordance with the *Likelihood and Consequences Matrix* illustrated below can enable all parties involved in the valuation/appraisal process and assessment to fully understand and manage the risk inherent in property valuation/assessment.

It is imperative that the expectations are the same for the User of valuations, the Firewall Unit and the Professional who produces the valuation/appraisal. They all need to *agree* where a given valuation task is categorised within the matrix.

Table 4 – Likelihood and Consequences Risk Matrix

Likelihood	Consequences				
	1 Insignificant	2 Minor	3 Moderate	4 Major	5 Catastrophic
A Almost Certain	S	S	H	H	H
B Likely	M	M	S	H	H
C Possibility	L	L	S	H	H
D Unlikely	L	L	M	S	H
E Rare	L	L	M	S	S

Source: James Crown, National Management Education Centre

Interpreting the results...

Unacceptable Risks

H = a High Risk - Senior Management and Resources needed

S = a Significant Risk - Senior Management attention required

Acceptable Risks

M = a Moderate Risk - management responsibility to Instruct

L = a Low Risk- standard operating procedures to handle

Categorising the task can be undertaken in consultation between the relevant parties.

It would be interesting for you to consider the matrix and sit down with your client/User and other groups and see where they felt various cases of valuation/appraisal tasks you have undertaken, fall.

7. CONCLUSION

The understanding and ability to grade the risk level and / or its sensitivity across various property types will lead to greater certainty in valuations, BPO and will reduce the level of risk for all parties.

8. DISCLAIMER

I would like to draw to your attention that the views presented in this paper are my own; and should not be construed as representing those of State Government of Victoria, Australia.

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BIOGRAPHICAL NOTES

Simon Adcock

I have had a wide range of valuation experience in undertaking valuation tasks on major commercial valuation sites, major office buildings, residential development sites and specialist properties with some projects and values in excess of \$1 billion. In recent years, as Manager, Client Valuations, Valuer-General Victoria, Land Victoria, I have lead the team for the development of procurement of valuations from the private sector and the related management of these valuations to enable government to achieve their desired goals.

I have spoken at a number of international conferences since 1996 on topics covering such issues as “Professionals Managing Professionals”, “The Assessment of Compensation for Property Acquisitions and the Development of a Global Lease”. I am a member of the Australian Property Institute and a member of the Victorian division of the Institution of Surveyors Australia Inc. I have promoted the benefits of FIG to the Victorian Government which, via Land Victoria, strongly supports my endeavour to obtain the position of Chair of Commission 9 in the future.