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GUEST EDITORIAL

European Valuation Standards 2020
Michael P. Reinberg _____ page 2

#01 **Endemic crisis valuation**
Eduardo Elguezabal _____ page 5

#02 **EVS 2020 - the income approach to real estate valuation - Part 2**
Marcin Malmon _____ page 12

#03 **"Panta Rei"**
Fotis Stergiopoulos _____ page 15

#04 **EVS 2020 is focused on the future**
Danijela Ilić _____ page 18

#05 **AVMs recognised as valuer's tools for loan origination**
Krzysztof Grzesik _____ page 23



GUEST EDITORIAL

European Valuation Standards 2020

EU focus, valuer relevance and creative disruption



Michael P. Reinberg

EVS 2020 has the same structure as its predecessors, yet it is a radical shift from the past.

I. **The Blue Book remains in lock-step with EU law and policy, but eliminates unnecessary references to EU legislation and case law and clarifies key EU concepts**

Lock-step

- EVS definitions and concepts are rooted in EU law and reference it.
- Key EU valuation influences such as energy efficiency, sustainability and Advanced Statistical Models are covered in detail.

But we have eliminated:

- valuation-irrelevant EU definitions
- and entire guidance notes (GNs):
  - on EU freedoms of great intrinsic importance to all professions, but not really requiring EVS 'guidance', such as Cross-border Valuation
  - on EU law touching on valuation, but of no real practical interest, such as the Alternative Investment Fund Managers Directive
- as well as dispensable EU references in the Code of Conduct

And for the first time, we have taken the initiative of clarifying nothing less than the definition of Market Value in the EU Capital Requirements Regulation, introducing the concept of 'acting independently of each other' to offer an alternative to the disastrous translations in EU law of the Anglo-Saxon expression 'arm's length transaction'.

II. For EVS 2020 , we systematically weeded out concepts and whole sections of limited practical use to valuers and introduced high value-added material

We eliminated GNs on Assessment of Investment Value and Commercial Loan Specification as well as an information paper (IP) on European Property and Market Rating because they just didn't make the cut in terms of valuer relevance.

For the same reason, sometimes we did not eliminate texts altogether, but made them tighter, leaner, more focused and thus more readable

- either by keeping the stand-alone text but pruning it: Valuation for Insurance Purposes
- or by eliminating the stand-alone text but incorporating useful parts elsewhere: parts of the GN on Valuation for Lending Purposes transferred to the Standard on Valuation Bases other than Market Value (MLV)

But all this merciless killing and pruning was for a purpose. To make room for new life!

- Extension of Highest and Best Use (HABU) to encompass Hope Value
- The rationalisation/simplification of the Minimum Terms of Engagement
- Now attached to the reporting standard, a 55-item valuation report for residential property
- Replacement of the modest Information Paper (IP) on methodology by the ground-breaking EVS Part 2 Valuation Methodology by Krzysztof Grzesik, Danijela Ilić and the much regretted Roger Messenger, including detailed exposition of key concepts such as income approach and depreciated replacement cost

And complete new IPs on subjects of real interest to practicing valuers:

- Multiple Interests in Residential Property
- Listed Residential Property
- Residential Tenancies and Rent Control
- Residential Valuations and Equity Release

Extension of HABU to encompass Hope Value was long overdue

"The concept of 'highest and best use' (HABU) is integral to Market Value and is the use of a property that is physically possible, reasonably probable, legal or likely to become so, and that results in the highest value of the property at the date of valuation." EVS 1.4.3.4.

The fundamental reason for this change is that Market Value is what people are willing to pay, not in the future, but today; and what they are prepared to pay today is influenced by commonly held expectations about future events.

Apart from the focus on valuer-relevance, we had another overarching, cross-cutting concern: to emphasise tasks that require a qualified valuer's expertise and experience.

Prime examples are:

- the detailed inspection requirements in EVS 4 The Valuation Process;
- the Valuation Report for Residential Property annexed to EVS 5:

III. EVS 2020 disrupts valuation practice by adapting energy efficiency valuation to EU constraints on the viability of energy-inefficient buildings

In fact, EVS 2020 creates energy efficiency valuation.

EVS 2020 comes to grips with the imperative of determining the value of energy efficiency in buildings in a Union which is increasing the legal constraints on energy-inefficient buildings. Accordingly, EVS 2020 upgrades energy efficiency valuation to Standard status and advises valuers to integrate legal constraints on the sale or rental of low-performing buildings into their determination of Market Value.

From beginning to end, the Standards were designed in the belief that the valuation profession must be conscious of the real added value that quality valuation brings to markets and society, and must imbue clients and public authorities with an understanding of how the valuer reached the determination of value.

All sections were reviewed in that light, and all new parts passed through that filter.

It was a collective effort based on a clear concept of the needs of society and the future of the profession, providing our 70.000 valuers, their clients and the European and national public authorities with the underpinning for rigorous evidence-based determination of value. ▲

Michael P. Reinberg PhD REV FRICS CRE
Chairman of the European Valuation Standards Board

#02 Endemic crisis valuation

A twenty year dialectic between norm and practice in Argentina

Argentina is periodically rocked by economic, financial and political crisis. At its worst, the social and market disruption reaches levels that most Europeans haven't experienced in living memory. Eduardo Elguezabal, a leading Argentinian valuation authority, explains how valuation practitioners navigate these challenges.



Eduardo Elguezabal

Argentina's Tribunal de Tasaciones de la Nación (TTN) (National Appraisal Agency of Argentina) appraises expropriations and all assets that are bought, sold, hired or licenced by the State. In 2001, it was officially charged with drawing up the National Valuation Standards, which would be mandatory for official activities and would have the status of guidelines for general valuation purposes.

A real dialectic then began between current practice and the proposed standards, leading to the creation of 28 specific standards for all types of movable and immovable properties for the purposes of valuation[1].

International standards were consulted, and in particular Spain's mortgage valuation standards. At the end of the 1990s and in the early 2000s, a modicum of economic stability enabled the return of mortgage credit, and the Spanish framework was of value insofar as it could be adapted to the broadest range of valuation purposes.

Structuring the body of standards was the first task, and it wasn't long before a dialectic between practice and sound theory appeared.

1 National Valuation Standards (www.ttn.gov.ar)`
The fundamental premises:
- Conceptual breadth, so as to overcome dogmatic inflexibility.
- Adaptability, to deal with the changing circumstances of the modern world, which are reflected in property values.
- The aim: to ensure best professional practice in the matter, promoting clarity and transparency in valuations, by proposing:
  - To define the general principles expressed as a whole.
  - To adopt concepts of value.
  - To give explicit technical definitions of an operational nature.
  - To clarify technical procedures in order to ensure clear content in reports and obtain well-grounded values.

"... we took into account best practice of experienced valuers in designing the standard."

Case 1: practice and standards for urban planning legislation

When it comes to drawing up standards, who wouldn't put Highest and Best Use at the top of the list of guiding principles? We all take these into consideration, whether explicitly or implicitly, but the valuer needs to use broad criteria when looking at the harsh text of a standard.

When it came to structuring the regulatory plexus that would come to be known as the National Valuation Standards, we knew that we had to start off with certain general principles. One was that a property should be valued according to the best opportunities for its use, because that is how the market interprets its objective value. But what defined this highest and best use? Should we mechanically adopt planning regulations and the construction potential they entailed? Have planning regulations always reflected society's actual behaviour? Specifically, have we always built everything we were allowed to in our cities?

Planning in developing countries tends to be indicative of the direction that the planner and the authorities see urban growth taking, based on observed trends, which does not always coincide in the present or the immediate future with the area's actual situation in terms of buildability. It clearly does in urban centres and heavily developed areas, but not in peripheral areas. In reality, to be rigorous in these cases, we would have to assess the maximum buildable capacity by means of a kind of "present value", as time also plays a role.

To conclude, we avoided any explicit mention of the principle in Standard 1 and gave preference to the direct comparative method for land rather than the residual or repercussion value of the land, which was reserved for central areas or for verification purposes. We therefore avoided the residual method being applied as a matter of course in peripheral urban areas, because if the theoretical buildable capacity was taken literally, values would rocket beyond any market capacity. **Basically, we took into account best practice of experienced valuers in designing the standard.** ▲





“ … what happens when the economy hits a crisis and transactions grind to a halt? ”

Case 2: Sustainable values in contexts of economic volatility

The comprehensive direct comparative method of obtaining market value is the most appropriate for ordinary properties. But what happens when the economy hits a crisis and transactions grind to a halt?

There is always the possibility of separating land and construction when dealing with properties, and of making separate valuations based on the duly calculated cost of replacing the depreciated building. These prices are relatively more stable, and although the result is not a completely fair market comparison, it does allow for a response to crisis situations. Moreover, when there is a lack of sufficient data on transactions, it allows the value to be calculated by means of the rental profitability, which continues to be reasonably active, even in times of crisis.

This is what the valuers of several private banks did in periods of economic instability, using other methods to find market value.

Major fluctuations in currency values against the dollar and the existence of a parallel market, force one to rethink the terms of any comparison, applying common sense, particularly in countries that view foreign currency as a means of holding value.

For all of the above, valuation by means of more than one method often becomes necessary. Here also the standard should have enough flexibility to contemplate different emerging situations.

See Julio Villamonte’s comments on the next page.

Macro, micro and valuation

By Julio R. Villamonte (*)

A valuation provides an unbiased estimate of the market value of an asset on a particular date and **within the verified intrinsic and extrinsic conditions at the time the valuation is made**. In Argentina, the practice of valuing properties can in certain circumstances take on very particular characteristics.

Property is usually sold in foreign currency (US dollars), because owners believe it will then be easier to calculate price changes over time in constant terms, as holding dollar bills is the most widely used alternative form of savings.

This culture of foreign currency savings is the result of bad experiences, where macroeconomic imbalances have caused sharp devaluations.

Also, the main fixed assets are urban properties, meaning that, in consolidated centres, the evolution of macroeconomic variables linked to currency, inflationary and finance policy has an impact on the performance of the usual mechanism of microeconomic balance caused by supply and demand.

Property cycles therefore acquire a particular dynamic, being linked not only to the fluctuations of end-user demand, but also to the expectations of investors, who decide to buy property as a way of saving.

Within this framework, **it is very helpful to use different valuation methods for the same property**, determining its value based on a range of economic criteria, **incorporating both the logic of demand and the logic of supply so as to calculate a balanced market price**.

Inflation, exchange rate variation, split exchange, variation in country risk and in financing rates should be seen to be just as important as physical variables, location variables, the provision of infrastructure and equipment or changes in planning regulations.

Applying technical standards therefore becomes very helpful when establishing control points for each of the methods applied, as it restricts the degree of freedom applicable to the task and contributes in great measure to quality assurance. ▲



Julio R. Villamonte

(*) Vice-President of the National Appraisal Agency of Argentina.

Case 3: So how do we value a state company?

The National Congress of Argentina passed a law to expropriate the country's national airline for reasons of public utility. Established as the country's flagship commercial airline, it had been privatised in the 1990s and had passed through several hands since then. The law established that its value should be calculated by the National Appraisal Agency of Argentina.

On the basis of a study led by ing. Daniel Martín (2) and a methodology described by prof. Vicente Caballer Mellado (Valencia Polytechnic), the body used the 'substantial value' method (assets at market value minus audited current liabilities), **because Argentinian legislation literally does not allow hypothetical profit to be taken into account in expropriations, which eliminated the possibility of valuing by profitability**. It was the first experience of its kind.

The substantial value method was chosen above book value and profitability value, as the company being expropriated was an airline which, like so many others, was accruing growing deficits. Here, too, an alternative to the usual approach was required, and this then became a specific technical standard.

Subsequently, the National Congress determined by law that the National Appraisal Agency of Argentina should determine the value of 51 percent of the shares of the country's main petroleum company. As in the previous case, this company, which was set up as a state enterprise in the 1920s, when oil was discovered in the south of Argentina, was later privatised in the 1990s.

In this case, to value a company that was making a profit, the Body verified the substantial value of the legally requested expropriation using the yield value (defined as the value a company has according to the expectation of generating economic returns), arriving at an agreed value that enabled the process to go ahead and avoided legal proceedings. ▲

"Argentinian legislation literally does not allow hypothetical profit to be taken into account in expropriations..."



2 Daniel E. Martín, Presidente del TTN en "Ingeniería en tasaciones. Tasación de empresas", Editorial Maipue. 2021. ISBN 978 987 8321 98 1

Case 4: More challenges

The public authorities asked the National Appraisal Agency of Argentina to value various central properties, some of which were next to railway lines, so that these could be sold off. They would then almost simultaneously be offered at auction to a restricted market of buyers. The expertise of trained valuers did allow in this case for an orthodox application of the residual value, with the base price of the auction serving simply as a reference to start the bidding.

Elsewhere, the State decided to create an office dedicated to reconciling the property tax value criteria of the different provinces.

How to develop coherent and sustainable systems of market-linked tax valuations, which must be applied by a public authority, in changing macroeconomic situations?

The question led to the use of automated valuation models, which applied algorithms that use large amounts of data to calculate the values applicable to each point being considered. In short, if these procedures are accepted and adopted, the question arises as to what role the expert valuer plays.

Although this is dependent on its application to tax values for property tax, which require nothing more than reasonable equivalence to the market and internal equity, even in these cases there is someone behind the algorithm and the factors taken into consideration; which is where the expert and clearly explained opinion of the valuer is needed, in a new role that requires their judgment and goes beyond the technology applied and the standards on which it is based.

In recent times, the public sector has needed to value extensive land occupied by precarious housing and to regularise tenure and grant property titles. This led to the formulation of specific regulations or procedures to be framed in the governing principles of all appraisals. ▲

"How to develop coherent and sustainable systems of market-linked tax valuations … in changing macroeconomic situations?"

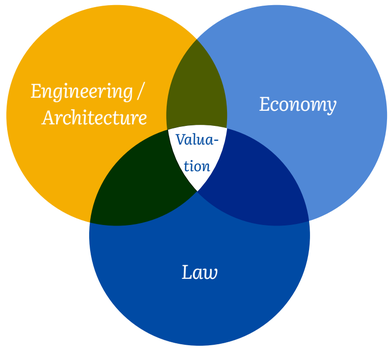


"Valuers must be clear and unequivocal and "put themselves on the line" at all times. It's their duty to society."

IN CONCLUSION

Faced with this entire panorama, valuers must continue to exert an interdisciplinary perspective, maintaining a delicate balance between the economy, specific knowledge of the asset concerned, and the regulatory framework linked to the valuation.

And that interdisciplinary perspective should take precedence in defining the technical standards, ensuring they remain solid and relevant, feeding off the valuer's practices.



Finally, it occurs to me to refer to one particular aspect of the valuer's work. I maintain that the valuer always speaks in the indicative mode.

This takes on particular relevance in mortgage valuation, in which valuers must ensure that their criterion remains independent, whether in direct relation to the bank or through the valuation company.

The valuer will speak in the present tense when giving a value today, in the past tense when the valuation is for a date in the past, and even in the future tense when they are required to forecast a future situation. But always in the indicative, not in the subjunctive or the conditional. Valuers must be clear and unequivocal and "put themselves on the line" at all times. It's their duty to society.

And in times of economic and political change, valuers must act and comply with their duty as objectively as possible. **The technical standards must provide support here by being solid but not rigid.** ▲

Eduardo Elguezabal is a regulatory consultant for the National Appraisal Agency of Argentina. He teaches at the School of Architecture at the University of Buenos Aires (UBA) and the Universidad Nacional del Litoral (Santa Fe, Argentina), and is director of the post-graduate Valuations programme at the UBA and the Polytechnic University of Valencia, as well as teaching at the University of Jaén and on the Policymakers master's course at the Polytechnic University of Milan. He currently acts as juror for official appraisers of Argentina's Supreme Court of Justice.

#02 EVS 2020 – the income approach to real estate valuation – Part 2



Marcin Malmon

In European Valuer Issue No. 18 of March 2020, I provided an overview of the Income Approach to Valuation described in European Valuation Standards (EVS 2020). The article focused on the different types of valuation models described in the standards. This article explains the difference between the types of yields / discount rates employed in those models.

It is not often recognised that valuers may employ a variety of yields in the valuation of investment properties and there is no consistency of approach. When it comes to defining yields, valuers speak different languages. Anyone reading a selection of valuation or property market reports will not fail to notice reference to a variety of different types of yield, for example, initial yield, all risks yield, equivalent yield, equated yield, gross yield and net yield.

It is important to understand that when for example a prime property has been sold at a 5% "initial yield" this may perhaps actually translate into a 6% "equivalent yield" if the property was under-rented at the date of transaction, or a 4% "equivalent yield" if "over-rented". It is also important to know whether a quoted yield reflects costs of purchase or whether it is based on the contract price alone. The difference could be as much as 50 basis points. Confusion also arises because whereas "initial yield" is often used as the simplest yardstick of property valuation (i.e. the current rental income divided by the purchase price multiplied by 100), in some countries (for example in the UK) the costs

"When it comes to defining yields, valuers speak different languages."

"Capitalisation may be undertaken by means of a very simple mathematical model."

of purchase are added to the transaction price for the purposes of analysis. The result is a "net initial yield". And yet, all internationally recognised valuation standards including European Valuation Standards emphasise that Market Value excludes costs of sale or purchase.

EVS 2020 divides the income method used within the Income Approach into two types of model:

- a. traditional income growth-implicit models, known as capitalisation methods, including direct capitalisation, term and reversion, layer (hardcore and top slice) and growth-implicit discounted cash flow models, and
- b. income growth-explicit models usually known as Discounted Cash Flow (DCF).

Capitalisation is a market-based model which relies on strong evidence of market rents and market yields (capitalisation rates). It relies on an active and liquid property market, both for investment and for lease, and requires sound analysis of property sales and property leases. Capitalisation may be undertaken by means of a very simple mathematical model. If at the date of valuation, property is leased at a Market Rent, it can be assumed that this income is perpetual (i.e. income assumed to be constant at Market Rent) and, if it is possible to derive capitalisation rates from market transactions, direct capitalisation is applied based on the formula: capital value equals net operating income divided by the capitalisation rate. The income that is capitalised is the expected income for one year (usually for the first year of calculation). This model does not usually reflect any potential future variation in rental income. The capitalisation rate or "**all risks yield**" reflects all of the market's perceived expectations about risks, expectations of positive benefits (in the form of income growth or growth in capital value) and other expectations of investors in the market. Simply put, this is a capitalisation rate derived from the analysis of a sale price of a comparable property which was let at a full market rent at the time of sale.

More recently, income growth-explicit DCF valuation models as in b) above have become common but they have also been confused with the equally popular growth-implicit DCF models as in a). Indeed, a party relying on a valuation of an investment property needs to understand whether the valuer has discounted the income flow from the property on the basis of an "implicit" or "explicit" cash flow. In constructing an "implicit" cash flow, the valuer avoids any subjective assumptions about potential future market-driven changes to income from a property. The market's perception of future income growth and risks is reflected in a so called "**equivalent yield**".



Marcin Malmon REV MRICS is an Associate Director at KPMG in Poland, Real Estate Advisory and Valuation Team.

EVS 2020 defines equivalent yield as "the single discount rate which, when applied to all income flows, results in a present value equal to the capital value of the investment. It is in the internal rate of return that the cash flow changes are allowed for implicitly. The income flows reflect current, actual and market rents and costs."

On the other hand, an "explicit" cash flow reflects forecasts of future market-driven changes in rental income and operational costs. This is a model based on the premise that the value of the property is equal to the sum of the present value of all future cash flows. The process involves the addition of the present value for each future cash inflow and the present value of the resale price at the end of the period.

The explicit DCF model requires the valuer to forecast the cash flow based on market expectations and to discount it at a rate expected by investors in the market. This is in practice often achieved by rental indexation during the cash flow period and discounting by the adoption of a so called "**target** or **equated yield**".

"Target or Equated Yield" is defined in EVS 2020 as "*the discount rate applied to the cash flow projected during the life of the investment and to the reversionary or exit value at the end of the hold period. Under such scenario, income projections reflect expected future rental changes.*"

The above article presents a very simple overview of certain elements of income approach methodology described in EVS 2020. It mainly serves to highlight the differences that exist between the various yields or discount rates employed by valuers. For a fuller understanding of the complexities of constructing cash flows and deriving yields/discount rates, readers are advised to refer to the full text of EVS 2020 Section II Methodology. ▲

The market's perception of future income growth and risks is reflected in a so called "equivalent yield".

#03 “Panta Rei”

“Panta Rei” or “everything flows”, i.e. is changing, is an ancient Greek expression attributed to the great pre-Socratic philosopher Heraklitus (6th-5th century BC) to denote that nothing stays the same and perennial movement is the only reality.



Fotis Stergiopoulos

As TEGOVA pursues its development of plant, machinery and equipment standards, education and recognition, European Valuer increases its focus on PME valuation.

As you read these lines sitting comfortably, you may wonder, *“what on earth’s name does this have to do with me?”*. I kindly ask you to pause for a second and ask yourself: where would you – as a valuer – stand, if things suddenly *“stopped flowing”*? The world would be stagnant and all things that matter, including assets that have a value would be static. There would be no necessity to “re-valuate”. Isn’t it indeed the power of outward change, “perennial movement” as Heraclitus claimed, that drives our need to continuously assess the Social, Technological, Economic and Political framework – usually abbreviated to “STEP” – which determines the value of assets and gives substance to all methods and tools used in our valuations?

Being active in the valuation of plant, machinery and equipment, I have to admit that we have come a long way in the electromechanical sector since the development of James Watt’s (1736-1819) steam engine that spurred the dawn of the Industrial Revolution, which shaped the future not only of Great Britain, his native country, but of the whole world. We still, to date, use the term “horsepower” (hp), as a romantic reminder of the times when people compared the work performed by engines to that of horses. The rate of technological change accelerated exponentially in the centuries that followed, to come to our present unprecedented pace of technological breakthrough due

> *“ … where would you – as a valuer – stand, if things suddenly “stopped flowing”?”*



to advancements in Information and Communication Technologies (ICT), which in many cases we find difficult to follow, and what's more, to assess their impacts and their value.

It is a duty of the valuer to stay in pace with this evolution. This is particularly true for valuations of plant, machinery and equipment that are strongly correlated to technology. In that respect, one has to closely monitor the developments that may alter prices when trying to conduct market research to collect comparative data, in an effort to estimate the value of a production line or other significant parts of equipment. The valuer has to develop an acute perception of the physical state of equipment in order to determine its depreciation due to its current use, taking into account potential upgrading and future maintenance needs due to advancements in technology which can determine its cost-effectiveness. What's more, assuming a value for the interest rate – when applying the discounted cash flow (DCF) methods in the case where the value of the equipment can be approached with respect to future income in the framework of the next 10-20 years – can be a real puzzle when considering the pace of technological evolution which could even render a particular type obsolete after a certain period of time.

Plant, machinery and equipment valuation is a dynamic field prone to change and evolution. But how should we evolve, what should our compass be to not get carried away by the frantic pace of modern change?

We, as valuers, especially in the electromechanical sector, are like passengers on a train; things outside our window seem to travel fast and we always observe objects from different angles, perspectives and terms of use. But all types of trains, from the earliest steam trains, to diesel, modern electric and even magnetically elevated ones, have one thing in common: they run on tracks, rails and predefined paths, no matter how fast they travel.

For valuers like ourselves, the "rails" on which we must travel are standards and well-defined patterns for conducting our operations. In the plethora of potential plant, machinery and equipment, it is the formulation and adoption of standards that will ensure that we continue to perform as expected.

"The valuer has to develop an acute perception of the physical state of equipment."

“It is high time for valuations of plant, machinery and equipment to be solidly grounded in standards, and Europe should lead the way.”

It is high time for valuations of plant, machinery and equipment to be solidly grounded in standards, and Europe should lead the way. We need not “build from scratch”; TEGOVA’s tried, tested and widely adopted European Valuation Standards pave the way with a series of real estate applications that can be adjusted and refined to reflect the intertwined nature and vast variety of plant, machinery and equipment. Methods and procedures for incorporating the different dimensions of technology have to be applied to rationally reflect the current market value of the asset. This way we can rest assured that we will always remain “on track”... no matter where Heraclitus’ “perennial movement” leads us. ▲



Fotis Stergiopoulos Electrical Engineer, PhD

#04 EVS 2020 is focused on the future



Danijela Ilić

With tabular comparison of EVS 2016 and EVS 2020

These are times of rapid change in almost every aspect of our lives, and we have to embrace and accommodate them in our professional practice to stay useful to society.

After extensive consultation among its members across the EU, candidate member states and beyond, TEGOVA launched the new edition of EVS in November 2020, at the peak of the second wave of the COVID 19 pandemic in Europe. Shortly before, TEGOVA launched the first-ever European Business Valuation Standards and both Blue Books in the new, rebranded design of TEGOVA's logo and products.

"Successive editions of the ECB's Asset Quality Review manual have given EVS precedence over all other standards."

The basis for changes in this 9th edition of EVS comes primarily from the confirmed recognition of EVS in EU banking supervision rules and regulation: successive editions of the ECB's Asset Quality Review manual have given EVS precedence over all other standards, inspiring TEGOVA to help the European authorities further in the present edition. In particular, in the light of Directive 2014/17/EU (the Mortgage Credit Directive), TEGOVA has dedicated four out of seven European Valuation Information Papers (EVIPs) to different issues in valuation of residential properties and the Annex to EVS 5 "Reporting the Valuation" presents a common European Valuation Report for Residential Property.

EVS 2020 complies with the EU regulatory framework impacting the valuation of real estate and contains an overarching text "'European Union Legislation and Property Valuation" serving not only valuers, but also European and national supervisory authorities, policy makers and academics.

These standards cover key EU valuation influences such as energy efficiency, sustainability and advanced statistical models and have left out certain concepts and whole sections that were present in EVS 2016 but were of limited practical use to valuers.

An important part of practice for the majority of valuers is valuation for mortgage lending purposes. When it comes to residential properties, we can expect high impact from the European Banking Authority's (EBA's) Final Report — Guidelines on loan origination and monitoring (29 May 2020) on valuation practice and this is the subject of the new EVIP 7 "Advanced Statistical Models".

At the TEGOVA General Assembly in Sofia on 12 October 2019, there was a very high level debate relating to relevance of asking prices as market evidence. That led TEGOVA to commission a survey from Nick French, Professor in Real Estate, to determine the range of practices, and variations thereof, in using comparable data within the Market and Income Approaches to determine Market Value.

Three key conclusions of the survey are:

1) there is a relationship between the ranking of comparable evidence and the transparency of the market in question and that ranking will vary between countries.
2) the definition of comparables or comparable evidence is not absolute, and valuers in different markets use the term differently. This should be recognised and care should be taken not to view the ranking of comparable evidence as a rigid universal framework.
3) a good valuer in a specific market will know the relationship, at any point in time, between the asking price information and the likely market sales and thus, in the absence of other data further up the hierarchy, the use of such information is valid.

And as a result, in Part II. Valuation Methodology in EVS, we now have:

"6.2. Ideally the Comparative Method assesses Market Value through an analysis of prices obtained from sales or lettings of properties similar to the subject property followed by adjustment of the unit values to take account of differences between the comparable properties and the subject property. However, valuers should also have regard to other relevant market information and data upon which they may need to place greater reliance particularly in those markets or situations where information about transactions is either unreliable or simply not available. See Pricing to Market — An investigation into the use of comparable evidence in property valuation, by Nick French, June 2020."

The Cost approach is an approach that valuers will resort to only in certain rare cases. Perhaps for this reason it is, in general, modestly explained in valuation standards. Thanks to the great contribution of late Vice Chairman and former Chairman of TEGOVA, Roger Messenger, in Part II. Valuation Methodology, Cost approach and DRC is elaborated in detail with recommendations from his best practice and enormous experience using the Cost approach.

The EVSB reviewed all sections in the previous edition and as a result some were not carried forward in new edition, some were updated and merged in new sections.

"These standards cover key EU valuation influences such as energy efficiency, sustainability and advanced statistical models."

Overview of some of the most significant changes EVS 2016/EVS 2020

EVS 2016	EVS 2020
EVS 1 Market Value	Definition of Market Value same as in EVS 2016 and in the Capital Requirements Regulation: "*The estimated amount for which the property 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 being under compulsion.*" MV guidance-definition for the purpose of correct translation in different countries in EU and beyond: "*The estimated amount for which the property should exchange on the date of valuation between a buyer and a seller* ***acting independently of each other*** *after proper marketing wherein the parties had each acted knowledgeably, prudently and without being under compulsion.*"
EVS 1 HABU	In EVS 2016 MV is supported by "hope value" + HABU as per definition in Canadian Uniform Standards of Professional Appraisal Practice 2014 and The Dictionary of Real Estate Appraisal, Appraisal Institute. In EVS 2020, "hope value" is left out and HABU definition is extended to encompass uplift in value that is expected to result once such use is fully permitted or where relevant, other constraints have been lifted. "*The concept of 'highest and best use' (HABU) is* ***integral to Market Value*** *and is the use of a property that is physically possible, reasonably probable,* ***legal or likely to become so****, and that results in the highest value of the property at the date of valuation.*"

EVS 2016	EVS 2020
EVS 2 Valuation Bases other than Market Value	Replicated
EVS 3 The Qualified Valuer	Not directly replicated; eliminates unnecessary references to EU legislation; eliminates ISO certification
EVS 4 The Valuation Process	The desktop valuation as defined and referenced in EVS 2016 is left out; the only reference to desktop valuations in EVS 2020 is in EVIP 7 Advanced Statistical Models, citing EBA Final Report — Guidelines on loan origination and monitoring (29 May 2020). Rationalisation of the Minimum Terms of Engagement
EVS 5 Reporting the Valuation	EVS 2020 relates to full valuation report by default. All other types of valuation reports as referenced in EVS 2016 are left out. There is an Annex to EVS 5 - The EVS Valuation Report for Residential Property.
EVS 6 Automated Valuation Models (AVMs) adopted in 2017	Not carried forward into the new edition. EVS 2020 upgrades energy efficiency valuation to Standard status – EVS 6 Valuation and Energy Efficiency

EVS 2016		EVS 2020
EVGN 1	Valuation for the Purpose of Financial Reporting	Removed; some parts transferred to EVGN 2 Fair Value for Financial Reporting
EVGN 2	Valuation for Lending Purposes	Removed; some parts transferred to EVS 2 Valuation Bases other than Market Value (MLV)
EVGN 3	Property Valuation for Securitisation Purposes	Removed.
EVGN 4	Assessment of Insurable Value and Damages	Not directly replicated; some parts transferred into EVGN 3 Valuation for Insurance Purposes
EVGN 5	Assessment of Investment Value	Removed.
EVGN 6	Cross-border Valuation	Removed.
EVGN 7	Property Valuation in the Context of the Alternative Fund Managers Directive	Removed.
EVGN 8	Property Valuation and Energy Efficiency	Removed; Not directly replicated into EVIP 1 The Impact of the Energy Performance of Buildings Directive on Property Valuation
EVGN 9	EMF and TEGoVA Commercial Loan Specification	Removed.
EVGN 10	Valuations: Compliance with EVS	Removed. The compliance with EVS and valuation process is detailed in EVS 4: The Valuation Process.

EVS 2016		EVS 2020
EVGN 11	The Valuer's Use of Statistical Tools, 2017	Some parts merged into EVIP 7 Advanced Statistical Models
		EVGN 1 Portfolio Valuation, new material in EVS

EVS 2016	EVS 2020
EC 1 European Valuers' Code of Ethics and Conduct	Not directly replicated. Some parts included in VI. European Valuers' Code of Conduct
EC 2 European Code of Measurement	Replicated into Part V. European Code of Measurement
PART 3 European Union Legislation and Property Valuation	Updated and transferred in VII. European Union Legislation and Property Valuation

EVS 2016		EVS 2020
EVIP 1	Sustainability and Valuation	Updated and transferred to III. Valuation and Sustainability
EVIP 2	Valuation Certainty and Market Risk	Removed.
EVIP 3	Apportionment of Value between Land and Buildings	Not directly replicated, updated and transferred in EVGN 4: Apportionment of Value between Land and Buildings,
EVIP 4	Valuation and Other Issues for Recurrent Property Tax Purposes	Not directly replicated; updated and transferred to EVIP 2 Valuation and Other Issues for Recurrent Property Taxation
EVIP 5	Valuation Methodology	Not directly replicated; material extended and transferred to Part II. Valuation Methodology
EVIP 6	Automated Valuation Models (AVM)	Removed.
EVIP 7	European Property and Market Rating: A Valuer's Guide	Removed.
EVIP 8	Fair Value Measurement under IFRS 13	Not directly replicated; some parts transferred to EVGN 2 Fair Value for Financial Reporting

EVS 2016	EVS 2020
	EVIP 1 The Impact of the Energy Performance of Buildings Directive on Property Valuation, new material in EVS
	EVIP 3 Multiple Interests in Residential Property, new material in EVS
	EVIP 4 Listed Residential Property (property protected by law), new material in EVS
	EVIP 5 Residential Tenancies and Rent Control, new material in EVS
	EVIP 6 Residential Valuations and Equity Release, new material in EVS

Although many sections existing in previous editions are removed, the new EVS comprises 400 pages of text of the highest relevance to valuers in their everyday practice.

It's a virtuous circle: the excellence of TEGOVA's standards and qualifications gives it more members with more expertise helping TEGOVA to stay abreast of the latest trends in valuation practice, providing our members and the valuation community with the tools for integrating these advances into their determination of value. ▲

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#05 AVMs recognised as valuer's tools for loan origination

But do they meet the confidence test?



Krzysztof Grzesik

Automated Valuation Models (AVM) have been in development for many years, most successfully in the USA, and their use for mass appraisal has become the norm.

In Europe, banks have relied on AVMs for monitoring the value of their property loan portfolios and it was only a matter of time before they entered the mainstream in the valuation of residential property at loan origination. That time has now come.

Under the Capital Requirements Regulation (CRR) all property loans given out by credit institutions in the European Union must be preceded by an independent valuation undertaken by a qualified valuer. The valuation process excludes the use of AVMs. The latter can only be used for "monitoring" purposes in between full valuations.

However, since the CRR entered into force in 2013 operators have strongly lobbied to allow the use of their AVMs for loan origination. During this time TEGOVA cautioned against use of stand-alone AVMs at loan origination pending increased transparency within the European AVM industry needed to judge the accuracy of the AVMs on offer. In this connection, TEGOVA commissioned two reports from Professor George Matysiak, a distinguished authority on valuation accuracy. The first report in 2017 pointed to the lack of transparency within the AVM industry in Europe, the second in 2018 proposed a set of criteria for measuring the accuracy or confidence in valuations performed by AVMs.

Clearly the concerns raised by TEGOVA over that last four years have been heeded by the European Banking Authority (EBA) in its Final Report setting out "Guidelines on loan origination and monitoring" issued on 29th May 2020. The guidelines will apply from 30th June 2021. In short, they open the door to the use of AVMs as a valuer's tool at loan origination. Their main provisions in this respect are set out in paragraphs 209 and 210 as follows;

"209.At the point of origination, institutions should ensure that the value of all immovable property collateral for loans to consumers and micro, small, medium-sized and large enterprises is assessed by an internal or external valuer using full visit with internal and external assessment of the property.

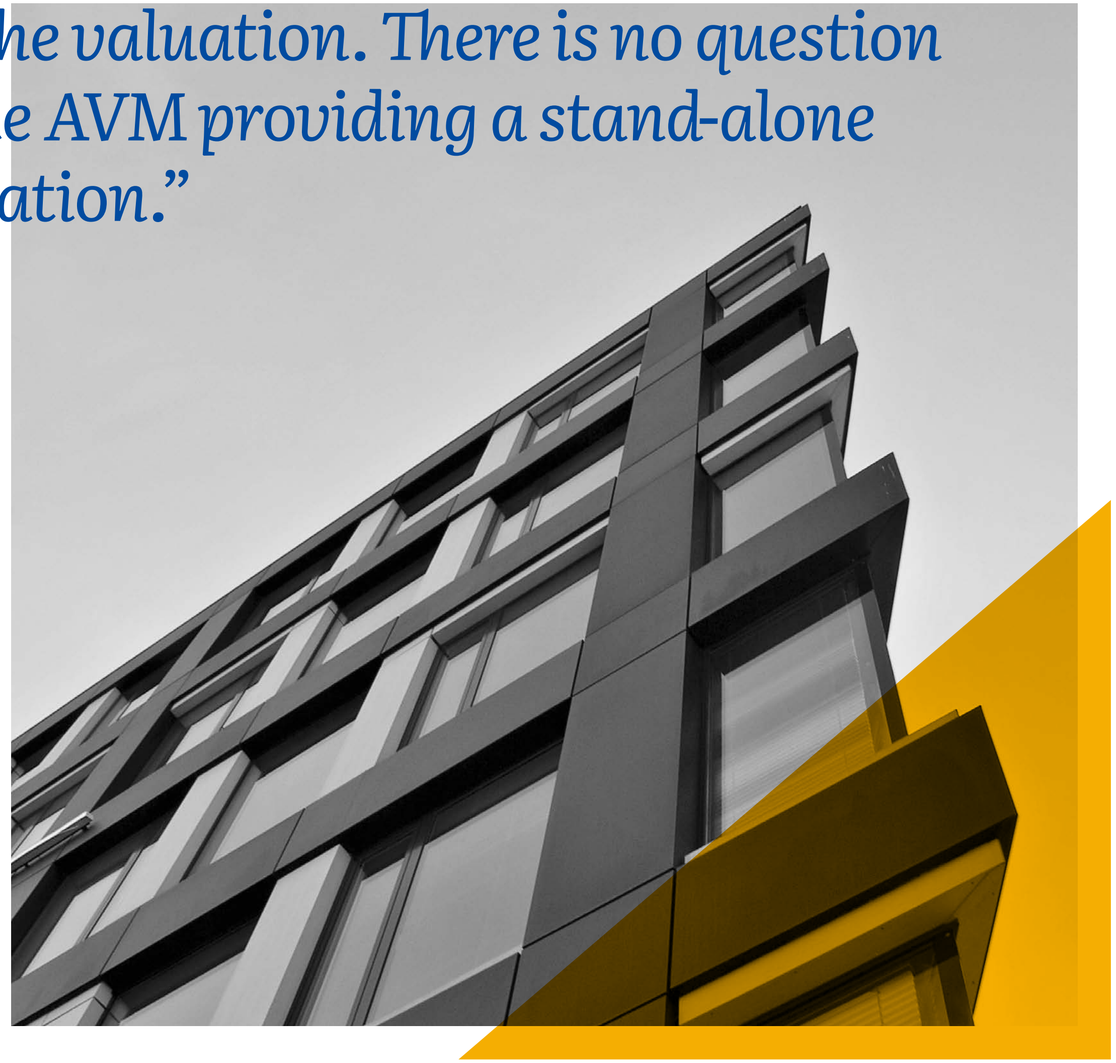
210. As a derogation from paragraph 209, for the purposes of a valuation of residential real estate in well-developed and mature property markets, the value may be assessed by means of a desktop valuation, carried out by an internal or external valuer and supported by advanced statistical models. The valuer remains responsible for the valuation, while the advanced statistical models should be used as supporting tools, meeting the conditions set out in Section 7.4, and including ***a confidence measure to indicate the robustness of the value proposal*** *and other relevant property-specific information. In this case, the value proposal should be assessed, reviewed and approved by the internal or external valuer, who should understand all inputs and assumptions considered in the model. If the confidence measure in the supporting advanced statistical model indicates low robustness, and/or other property-specific information gives rise to uncertainty about the value proposal, the valuer should choose a valuation method other than desktop valuation."*

It should be noted that the above provisions do not signal the unfettered use of AVMs without valuer input and without the need to assess the accuracy of the advanced statistical model used ("confidence measure"). Furthermore the term "advanced statistical models" seems to imply the use of only the most sophisticated AVMs.

In all cases, the valuer is responsible for the valuation. There is no question of the AVM providing a stand-alone valuation. Also, credit institutions must supply the valuer with "*a confidence measure to indicate the robustness of the value proposal and other relevant property-specific information.*"

If the confidence measure "*...indicates low robustness, and/or other property-specific information gives rise to uncertainty about the value proposal, the valuer should choose a valuation method other than desktop valuation*".

"In all cases, the valuer is responsible for the valuation. There is no question of the AVM providing a stand-alone valuation."



"EVS adheres to the European Banking Authority's Guidelines".

Whilst the EBA Guidelines do not define the term "confidence measure", TEGOVA has supported such requirement with the publication of the 2018 Matysiak Report "Assessing the Accuracy of Individual Property Values Estimated by Automated Valuation Models".

The Matysiak Report has now become essential reading for valuers engaged in residential property valuation for secured lending. In particular the report recommends 10 pieces of information which would enable valuers to assess the accuracy of an AVM report.

SUMMARY OF REQUIRED INFORMATION

1) The i) 50% and ii) 95% confidence intervals of the AVM valuation. That is, the estimated value ranges, containing the most likely lowest and highest property value
2) A clear explanation, accompanied by a 'legend', of the 'confidence score' or 'confidence level'
3) Confirmation that comparables have been used in the AVM valuation. If not, what method was used in the AVM valuation?
4) The standard deviation and the skewness of the comparable sales prices, or appraised values, used in the AVM valuation
5) The AVM model's overall accuracy, based on the comparable sales sample using: i) Mean Absolute Error ii) Median Absolute Error iii) 'Error Buckets' for the percentage of valuations lying within ± 5%, ± 10% and ± 20% of the Sales Price
6) The number and the overall geographic distribution of the comparables used in the AVM valuation
7) The range of comparables sales prices used in the AVM valuation
8) Confirmation of the earliest and most recent sales dates of the comparables used in the AVM valuation
9) If 'adjusted' comparable sales prices have been used, explanation of how they were adjusted
10) Confirmation of the Benchmark used in arriving at the figures in 4. and 5. above, sales prices or valuations, in arriving at the overall accuracy figures.

Finally it should be noted that a key element of EVS 2020 EVIP 7 Advanced Statistical Models is the opening sentence: "*EVS adheres to the European Banking Authority's Guidelines*".

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