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Valuing the purchase price of property – Is the purchase price of property the best evidence of value?

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Abstract

The role of the valuer in undertaking a valuation is to determine the value of the property being valued. In the case of mortgage valuations, where the purchaser has agreed and exchanged contracts on a property, it may be presumed that the role of the valuer is to confirm or reject the purchase price as value. In the case of rejecting the purchase price as value, the market value is determined by the valuer.

In the competitive mortgage market there is pressure on the valuer that suggests the purchase price of property is ultimately the best evidence of value. This paper firstly determines the purpose of the mortgage valuation given the proposition that the purchase price of property is the best evidence of value. Secondly cases have been reviewed that have presumably endorsed the proposition that the purchase price of a property is the best evidence of value. An examination of these cases will define the criteria valuers are to use to establish whether the purchase price of property is the best evidence of value. An examination of cases involving the refinancing of property where there is no sale over the subject property, coupled with an absence of comparable sales evidence has been undertaken, in establishing the importance of sales evidence in the valuation process.

Overview

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 confirm the value of the property being purchased and 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 against.

The valuation is a crucial component in the lending process and determines the amount that may be lent, or whether in fact the loan will be approved. Of particular concern, is where a purchaser has committed to the purchase of a property, by exchanging contracts on a 10% deposit and is seeking 90% borrowings against the value of the property and the valuation undertaken by the valuer is 15% below the purchase price. In this case the lender is financing 105% of the value of the property. Does the lender seek additional collateral from the borrower, refuse the loan or ask the valuer to revisit their valuation or engage another valuer.

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 is a question for consideration. A further consideration being, given that mortgage insurance may be taken out to insure the lender against default by the borrower, why is a valuation necessary given that lenders will cover themselves against default, by having the borrower pay for mortgage insurance. Further to this, what is the relativity between the cost of valuation advice versus the cost of mortgage insurance, which are both paid for by the borrower. Has the same pressure been brought to bare on mortgage insurance premiums compared with mortgage valuation fees by lending institutions. A number of cases involving litigation against the valuer have been reviewed to determine whether the purchase price of property is the best evidence of value and what valuers need to do to establish this as fact.

Following this introduction, section one examines the purpose of the valuation for mortgage lending purposes, section two details the importance of the evidence that underpins the valuation with cases that support the use of sales evidence, section three analyses the origins of the proposition that suggest that the purchase price of property is the best evidence of value. In conclusion, practise for valuers to assist determine whether the suggested proposition is applicable in each case is provided.

If the purchase price of property is the best evidence of value, why are valuations 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). Going beyond the guidance recommendation provided by the regulator authority, the evolution of mortgage lending and valuation practises over the past decade provides a further basis for this recommendation.

Over the past two decades there have been a number of changes to the valuation profession and the way valuers are engaged. Among these changes has been the hiving off of valuation departments by lending institutions and government departments. In lieu of direct employment valuers, are being engaged on contract. This has been seen as a way of creating an arms length distance between what may be referred to as the regulator and operator relationship. This relationship is one that has distinct advantages and disadvantages for both sides.

In the case of mortgage valuation work, many of the employees of lending institutions set up practise 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.

Insurance and Reinsurance of loans

A further and perhaps more esoteric reason for the regulator and operator relationship, is the ability for lending institutions to re insure their mortgages through the use of valuers who once move from an employee to contractor status in New South Wales, loose the protection of the Employees Liability Act 1991 (NSW). Section 3 (1) of this act states:

Employee not liable where employer also liable

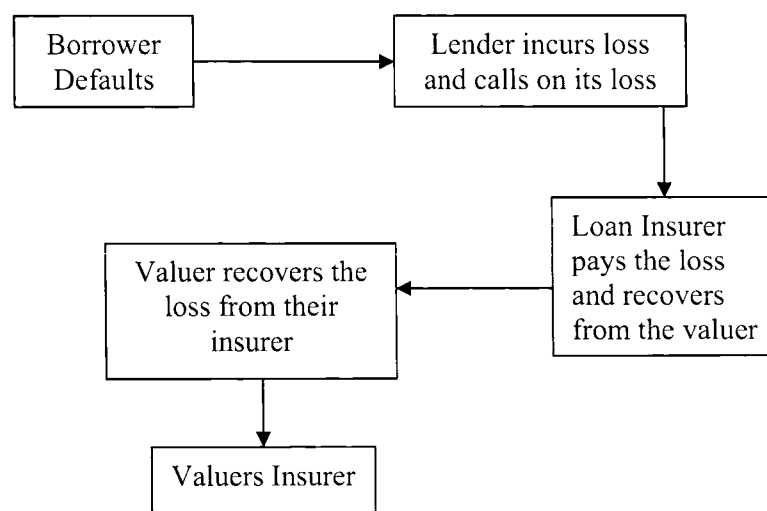
(1) If an employee commits a tort for which his or her employer is also liable:
(a) the employee is not liable to indemnify, or to pay any contribution to, the employer in respect of the liability incurred by the employer, and

(b) the employer is liable to indemnify the employee in respect of liability incurred by the employee for the tort (unless the employee is otherwise entitled to an indemnity in respect of that liability).

The change in status from employee to contractor necessitates the contractor carrying 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 valuers professional indemnity insurance policy is a reinsurance policy in the lending process. This is demonstrated in the following diagram:

Diagram 1 - Chain of Claims



An interesting disclosure made by the Australian Prudential Regulation Authority (2005) (APRA) 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 taking institutions (ADI’s). In effect, lending institutions, who are badged as authorised deposit taking institutions in this survey are also in the mortgage insurance business. The fact is that the valuer’s insurance acts as filters in the reinsurance process of spreading the risks through their insurance. This is best demonstrated in the following example:

Chart 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

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The above disproportionate cost of mortgage insurance compared to the valuation fee for lending purposes where the LVR is greater than 80% highlights that that the valuation profession may not fully recognized the role, responsibility and risk in the provision of mortgage valuation work for high LVR work.

To date, valuation advice provided to lending institutions have remained the domain of the lender. In some instances, valuations obtained by lenders are disclosed to borrowers, however in the majority of cases they are not disclosed. Since the conclusion of ACCC v Oceana Commercial Pty Ltd (2003) FCA, it is common practise for lenders not to disclose valuations to borrowers, in which the court held that the lender was not obliged to do so. This will change if Recommendation 9 of the Parliamentary Joint Committee on Corporations and Financial Services (2005) is adopted. This states that the disclosure of valuations by lending institutions to prospective borrowers be made mandatory.

The implementation of this recommendation may have implications for the valuer. Whilst the valuation arrangement is between the valuer and lender, the valuer has no direct annexure to the borrower. However, under a Service Level Agreement where the valuer indemnifies the lender against any action brought against the lender by the borrower resulting from the valuation, an additional dimension of risk will be brought to bare on the valuer. In effect, the valuation may become surrogate advice to the purchaser.

In the survey conducted by APRA, 96 ADI's and 8 LMI's were surveyed, not one valuer or valuation firm was included in the survey process. It is not known whether the issues raised in the survey relating to ADI's not having formal appointment processes to their panel's or fee negotiation mechanisms are to be referred to the ACCC for investigation.

A summary of the key finding of the APRA survey are as follows:

- Survey period July 03 to June 04
- Value of ADI lending to residential property during this period was \$233 billion
- 94 per cent of valuations are undertaken by external sources to ADI's
- A number of ADI's do not have a formal valuer appointment process
- 39 per cent of ADI's have Service Level Agreements with their panel valuers.
- 26 per cent of ADI's have removed a valuer within last twelve months
- 11 per cent of ADI's had issues with service or pricing
- 7 claims against valuers by ADI's during survey period, however, 75 per cent of LMI's have pursued a valuer through the legal process over the same period.

(Australian Prudential Regulation Authority, 2005)

An issue of concern emerges from this survey, given that only 39 per cent of ADI's have Service Level Agreements with panel valuers. In the absence of a Service Level Agreement, a technical breach of Rule of conduct 4, Schedule 2 of the Valuers Regulation 2005 may exist. Under this rule of conduct, it is insufficient for the valuer to receive an instruction to carryout a valuation for mortgage lending purposes from their client, without written confirmation of that instruction being provided back to the lender.

- (1) A valuer must not value property for another person (a "client") unless the valuer has provided the client with the following:
 - a. A written confirmation of the clients instructions,
 - b. A written disclosure of the costs of the valuation or the basis of calculating the cost of the valuation.

(Valuers Regulation 2005 – Schedule 2)

Where a Service Level Agreement does not exist between a valuer and lender, each valuation instruction must be confirmed by the valuer back to the lender.

Sales evidence & analysis in the valuation process

The formulation of 'market value theory' and deriving of market 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 the lay person.

This proposition 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 – and that is what I have to ascertain here – 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, "Recent experience has shown that current major mortgage lending institutions are applying great pressure for valuers to place greater emphasis on the subject sale" (Rooke 2002:48). 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 to this finding, was 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 Conservations 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.

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 (Hunt 1998:106).

This issue has been further 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.

Addressing cases where sales evidence is scarce and difficult for valuers to establish the value of property based on sales, particularly in cases where the property being valued is unique due to its location or style of improvements, it is here that the valuation profession is truly tested. It is interesting to note that the cases involving litigation against the property valuer are more prevalent in these circumstances where property is being refinanced in contrast to valuers valuing the purchase price of property.

A survey of 3000 valuers undertaken by the Australian Property Institute (2001), showed in 13 claims being made against valuers for residential valuations primarily undertaken for mortgage lending purposes. The survey showed that 37% of all claims made against valuers were for residential valuations. Drilling down and looking at cases where action against the valuer has been taken, 3 cases are cited:

- Trade Credits Limited v. Ballieu Knight Frank (NSW) Pty Ltd (1985)
Supreme Court NSW
- Ta Ho Ma Pty Ltd v Allen [1999] NSWCA 202 (28 June 1999)
- MGICA Ltd v Kenny & Good Pty Ltd & Anor [1996] 766 FCA

These three cases are important in analysing and assessing the use of residential property valuations and sales evidence. Each case has four common themes, these being:

- 1) Each property valued is a stand alone residential house.
- 2) In each case the property's were being valued for financing purposes.
- 3) There were no sales over any of the property's being valued as at or close to the date of the valuation, to guide the valuer.

- 4) Sales of property used as evidence to the subject property were not comparable and in each case there were a lack of comparable sales.

In contrast to the total number of property's valued, the number of cases that lead to litigation against the valuer is nominal. In saying that, what has not been taken into account are those 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.

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 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 (Daly et al 2003). Part of the sales analysis process is the adjustment of sales by valuers through interpreting buyer behaviour (Daly et al 2003). In saying this, a preliminary requisite in the sales analysis process is the selection of the most suitable sales. This maybe difficult as determining the most suitable sales, may require an element of buyer behaviour analysis. 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.

Regardless of the valuation approach adopted by the valuer, the input data to undertake a valuation is derived from the market place through the analysis of sales evidence. As highlighted in *Reading v The Valuer General*, sales evidence is the reference point upon which further investigation may be made and opinions of value expressed.

Is the purchase price of property market value?

It is suggested that *Inez v Dodd* (1979) established the principle that the best evidence available to a valuer is the sale of the subject property itself. This proposition may be refuted on two counts. The first being, the question of whether this was what the court actually stated in this case. The second count being the implications of *ACCC v Oceana Commercial Pty Ltd* (2003) FCA, in which the role of the valuer was further defined 25 years after the *Inez v Dodd* decision. In this later case the valuer advised the lender, that the purchase price of the property was well in excess (46%) of its market value. In contrast to this result, in the former case of *Inez v Dodd* (1979), the valuer valued the subject property at \$144,000 when the purchase price of the property was \$100,000 a fact the valuer chose not to investigate at the time of undertaking the valuation.

It is arguable that the role of the valuer in the lending process is not to confirm the purchase price of a property as its value, but in fact, to determine if the body of sales evidence confirms the purchase price is in line with market value based on sales evidence, with appropriate adjustment of those sales if required in determining the fact of value. The lack of sales evidence or comparable sales evidence itself, does not necessarily allow the valuer to rely on the sale price of the subject property as the best or only source of evidence. The task of the valuer, is to determine if the price at which a property is being purchased, constitutes market value, or is out of line. Again this exercise cannot be dismissed due to a lack of comparable sales evidence. The valuer cannot simply add the sale of the subject property to the sample of evidence (particularly when it is the only sale being relied upon) in determining its value, without applying the appropriate test defined in the *Spencer* case.

By virtue of the fact that a lender has requested a valuation of a property, the subject of finance is an indication that the certainty of its value has been brought into question by the lender. It is not the role of the valuer to consummate the purchase price of a property as value by virtue of its existence, without first applying the criteria of *Spencer* test. This is clearly spelt out in both in *Spencer v the Commonwealth* (1907) and again *Inez v Dodd* (1979) in which Carmichael J. refers back to the *Spencer* Case.

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 an

important point for valuers to understand what in fact was stated by the court in this case, which 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 carry out 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”***.

Before we discuss this point, we will briefly look at the extract from the paragraph in Spencer's case which Carmichael J quotes in his judgement relating to the business considerations of the bargaining parties in arriving at market value.

We must further suppose both to be ***perfectly acquainted with the land***, and ***cognizant of all the circumstances*** which might affect its ***value***, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its ***surrounding features***, the then ***present demand for land***, and the likelihood, as then appearing to persons best capable of forming an opinion, of ***a rise or fall for what reason*** so ever in the amount in which one could otherwise be willing to fix at the value of the property (Isaacs J. 1907:441)

When applying the Spencer test to the sale of the subject property in establishing that it constitutes the best evidence of value, it is the role of the valuer to ensure that the purchaser did meet the criteria set out by Isaac J. above. When the valuer is to rely on the sale of the subject property as evidence, particularly in the absence of adequate comparable sales evidence, the valuer must confirm that the purchaser has passed the Spencer test. Failure to do so does not mean the valuer has ignored the best evidence

of value, but means that the valuer *risks ignoring* the best evidence of value. The sale of the subject does not become the best evidence of value until the transaction has been tested by the valuer.

In undertaking this test, the valuer cannot rely on interviewing the selling agent as they did form the opinion of price to paid for the property. The selling agent is appointed and remunerated by the seller and their obligation and duty is primarily to their instructing party. The valuer has no option but to obtain the necessary information from the purchaser. This proposition is further confirmed by the following,

The circumstances under which sales take place should be investigated by interviewing the parties concerned in each transaction. Such circumstances could affect the comparability between the sale properties and the subject property being valued (Rost & Collins 1984:86).

At this point, most valuers may consider this to be an unrealistic process, not due to the information such investigations would reveal, but due to the time consuming and impracticality of the task. When an abundance of sales evidence leads the valuer to determine a value without concern, the task of vetting sales evidence seems even more impractical. It is where the availability of sales evidence is scarce that a detailed analysis of the subject sale is far more crucial and would lead the valuer to greater scrutiny of this transaction.

Where the sale of the subject property has been affected by circumstances not known to the valuer, which in itself leads to a price that may not be market value, the role of the valuer is to determine that fact. This was demonstrated in *Australian Competition & Consumer Commission v Oceana Commercial Pty Ltd* [2003] FCA 1516, in which the valuer appointed by the lender valued the property being purchased at \$100,000 as opposed to the purchase price of \$164,900. The lender successfully defended their decision not to disclose this valuation to the borrower, but instead asked the borrower to provide additional collateral to secure the loan. Further analysis of *Inez v Dodd* (1979) reveals an additional curial investigation that tests the proposition that the sale price of a property is the best evidence of its value. Of particular note in this case, was the evidence of the plaintiffs second expert valuer who advised the court that they had determined the value of the subject property at \$115,000, 15 per cent above the purchase price of the property in full knowledge of the facts.

Conclusion

The role of the valuer involves a number of procedural and cognitive tasks in determining value. The data mining process entails a mix of both procedural and cognitive skills in determining the most relevant sample of sales to be used. This further extends to the analysis and adjustment of the evidence selected. The valuer may be comforted by sales of property comparable to the subject, however what cannot be overlooked is the sale of the subject property. The court, seen as the final arbiter to many within the valuation profession has assisted the valuation profession by confirming that the sale of the subject may constitute the best evidence of value, subject to the transaction meeting the crucial test set out in *Spencer v The Commonwealth*. The valuation profession when determining the veracity of the subject sale, particularly when sales evidence is scarce will need to make an analysis of this sale as failure to do so would put the valuer at risk of ignoring the best evidence of value.

Schedule of Cases

- *Trade Credits Limited v. Ballieu Knight Frank (NSW) Pty Ltd* (1985) S.C. NSW
- *Griffith Co-Operative Society Ltd. v The Water Conservation and Irrigation Commission* (1926) 5 L.V.R. 190.
- *Ta Ho Ma Pty Ltd v Allen* [1999] NSWCA 202 (28 June 1999)
- *MGICA Ltd v Kenny & Good Pty Ltd & Anor* [1996] 766 FCA
- *Reading v. The Valuer General* (1923), 6 L.G.R. 132
- *Spencer v. The Commonwealth of Australia* (1907), 5 C.L.R. 418
- *Inez Investments Pty Ltd v. J.L. Dodd* 1979 SCNSW 5565 of 1976
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