



EXECUTIVE SUMMARY

SUBMISSION TO THE ROYAL COMMISSION

INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

Released: 6 November 2018

Note: This is the Executive Summary of the API Submission to the Royal Commission into misconduct in the banking, superannuation and financial services industry.

It contains the key themes and issues of importance to API members as they pertain to their experience of the Australian Banking and Financial Services sector.

This Executive Summary of the API Submission has been prepared for the benefit of the Members of the Australian Property Institute. It should be noted that it provides a synopsis of the key issues raised within the Royal Commission Submission but does not constitute the 'Submission' itself which remains the property of the Royal Commission.

The findings and recommendations contained within the Submission have been informed by inputs from members facilitated by an API expert panel established solely for this purpose. These were raised in written and verbal submissions to the API Banking Commission Expert Sub Committee Co-Chairs.

The API has therefore included in its submission recommendations which it believes will help preserve the integrity and independence of the valuation profession. These recommendations focus on both structural issues and on removing barriers to professional valuation practice and are detailed more fully in this Summary.

The API further seeks leave to appear before the Commission at either its November hearings, or at some future date, to provide further details of the issues raised and argue the case for implementation of the detailed recommendations contained within the Submission.

THIS SUBMISSION

On behalf of the Australian valuation profession, the Australian Property Institute (API) made a formal submission to the Royal Commission (the Commission) into misconduct in the banking, superannuation and financial services industry.¹

The API submission was made on the basis of interviews with members and 68 formal submissions provided by members to an API expert panel, convened to confidentially discuss the relationship between members and financial institutions now the subject of the Commission's inquiries.

The API's members provided information to the expert panel on the basis of anonymity. API's Valuer members have ongoing business relationships with the financial institutions the subject of the Commission's investigations and that provide much of their work. Any public appearance by a Valuer would place their livelihood in jeopardy. Therefore, the API has provided its written information in a form that does not include individual case details.

The Commission may find it useful to request that the API presents to the Commission information on the general nature of the complaints so that can be provided under the protections offered by the Commission. If the Commission is able to provide assurance of anonymity it may be possible for individual members to expand on their case experiences. Without such an assurance it would seem unlikely that individual members would risk their livelihood by providing information in open session.

KEY THEMES

The key themes and issues of importance to API members as they pertain to their experience of the Australian Banking and Financial Services sector can be summarised as:

1. Extension of a Duty of Care to Borrowers (Carnell Report (recommendation 8) and the Australian Banking Association Guidelines;
2. The Fee for Service Model - increasing pressure on valuation firms to reduce turnaround times and fees impacting the safety and integrity of the profession;
3. Intellectual Property; and
4. Professional Indemnity Insurance - premiums increasing and cover is being challenged by the extension of a duty of care to borrower.

The API believes that there is a direct correlation between an imbalance in the key structural risks and barriers to professional valuation practice outlined in this Summary, and some of the areas of banking activity already examined by the Commission. Structural arrangements under which Valuers deliver services have a profound impact on the operation of the financial services industry and importantly on outcomes for consumers and for Valuers themselves, often with adverse consequences.

¹ The API represents the valuation industry in Australia with around 8000 members across all states and territories and was established in 1926. See <https://www.api.org.au/about-api> The API is a regulator of Valuers and administers a professional standards scheme overseen by the Professional Standards Authority www.psc.gov.au

THE ROLE OF VALUERS IN THE AUSTRALIAN FINANCIAL SYSTEM

The API considers the crucial role of a robust valuation profession is to provide a higher level of independent certainty for the capital framework of the Australian financial system and by extension, the Australian economy. The valuation profession is essential to determining the capital adequacy of financial services entities in Australia. All professional Valuers take this role very seriously. A Valuers' highest priority is compliance with strict guidelines, methodologies, codes of conduct and practices, including the International Valuations Standards to ensure accurate, independent and robust valuations and for good reason.

Valuations are not only critical for the management of credit risk, they also underpin the many assets held by real estate investment trusts (REITs) and superannuation funds that manage the pension funds of Australians, as well as financial transactions and investments across the board.

The API believes that the role of this arm of the property profession, is a critical component to the successful underwriting of the credit process within all Australian financial institutions and is core to the stability of the financial services industry. Valuations are used as a cornerstone balance sheet measure, not only in the assessment of personal wealth, but backing the successful issuance of residential mortgage backed securities for all major and secondary Australian financial institutions. These are essential to the ongoing liquidity and funding requirements associated with the sector.

The quarterly Australian Prudential Regulation Authority (APRA) Authorised Deposit Institutions (ADI) Property exposure reports provide significant statistics for the Commission to refer. The Valuation industry is one of the critical credit underwriting components supporting, as outlined in its June 2018 report, both domestic housing loans (A\$1.5 trillion) and commercial property exposures (A\$315 billion), thus providing important external independent rating support to the Australian Financial Services Industry.

As an increased number of unregulated lenders enter the Australian financial market, it is imperative that the requirement for robust, independent and unbiased asset valuation be protected and enforced in order to maintain a stable and trusted Australian financial system. Concern should be had by the Commission to ensure that these entrants do not take their lead from the conduct and practices of the major banks.

Six barriers effectively diminishing or distorting the valuation function stand in the way of these objectives and deserve the attention of the Commission. These are:

- The use of an automated valuation model (AVM) generated assessment by financial institutions from a single system;
- Intellectual property ownership in valuations has devolved to banks;
- Imbalances of power between banks and Valuers have intensified;
- Valuer professional indemnity insurance now frequently covers poor lending practices and bank negligence;
- Kate Carnell in her Report at recommendation 8 and the Australian Banking Association have required valuations to be shared with borrowers raising greater opportunities for PI claims and extending a duty of care; and
- Mortgage brokers are stepping in between Valuers and bankers, attempting to reduce standards.

BACKGROUND TO THE SUBMISSION AND KEY ISSUES FACING THE VALUATION INDUSTRY

Banks and financial institutions interact daily with the valuation profession in large numbers. To date it does not appear that the Commission has focused on the financial institutions' interactions with the valuation industry and importance of this relationship to the stability of the property and financial sector.

From an external point of view, and with a rising property market, the valuation sector may appear to be working effectively and not in need of a review. From a historical and distant perspective, this assessment on a broad basis is likely to be fair. However, it is unclear whether the Commission is aware of the shift in valuation practices and policies by the financial institutions over the past 5-7 years. In the view of the API, these shifts raise an increasing likelihood of a failure of risk management impacting the financial services industry over the medium-term, the valuation (and by extension property market) in the short-term and in the longer-term on individual consumers.

The structural arrangements, under which Valuers deliver services have a profound impact on the operation of the financial services industry and importantly on outcomes for consumers. The Commission has already heard how outcomes from financial institution and bank interventions in the market may be adverse. In the view of the API, structural issues in the valuation industry, some initiated by financial institutions and banks affect consumers directly. The consequences are serious. For most Australians their home and/or their investment properties are largely the whole sum of their wealth. Incorrect valuation advice or the lessening of the quality of that information through desktop and automated valuation models (AVMs), particularly in the residential sector, has the potential to seriously impact the Australian economy.

The key shifts in valuation practices and policies mirror poor patterns of behaviours and conduct already identified by the Commission:

1. The increased use of AVMs has the potential to reduce the on-ground information gathered by full proper valuations, which, without a full appreciation of matters such as home condition or recent renovations, has the potential to diminish of the value of the evidence relied upon and subsequently may distort the market. While technology brings benefits as well as challenges, the use by banks of a single vendor's system that is not transparent or open to scrutiny creates opportunity for a property market that is open to manipulation. This is discussed in further detail below.
2. As bank assets are more and more regularly securitised for the purposes of lending, this use of data or algorithm based products significantly increases the risk to the balance sheets and potentially places bank shareholders (mum and dad and SMSF particularly) and consumers in potential of higher exposure to mortgage risk. Unlike share markets which are updated daily and highly transparent, property information can lag, and trends can be misleading. Consumers will have better protection from properly regulated and rigorous valuations, with experts working daily in the market, who have access to up to date information which is not always readily available to all.
3. Financial institution tendering processes that determine the relationships with Valuers as suppliers of services are heavy handed. At best, they lack appropriate governance and are overlaid with a significant power imbalance between small valuation businesses and the much larger financial institutions and banks.
4. Financial institutions and banks rely on Valuers not only to assess the risk of a property, but to mitigate the risk to the banks' balance sheets in the event of negligence through the leverage of Professional Indemnity (PI) insurance held by Valuers. The application and behaviour of

banks relating to potential losses, the use of bullying tactics to leverage PI insurance whilst threatening panel appointments/agreements and contracts etc. all before and without any proven cause creates significant problems for the viability of the industry. This has resulted in valuation firms being levered to settle losses through PI insurance without proper process or risk their work being removed. Continued misuse by banks of Valuers PI insurance could lead to an inability to obtain insurance in the Australian market which is already seen as too small to service on a global scale currently. This was significantly tested in 2011, with only one UK insurer left in the market threatening to walk away. Additional disincentives could have a major and unintended broader impact. The API responded to this to protect its members and consumers by establishing an Australian Property Professional Indemnity Scheme providing this insurance cover.

5. Internal valuations, whether done by branch managers or internal Valuers, raise the potential for conflicts of interests, lack transparency and independence for the consumer and there is variability between banks over the treatment of risk assessments.
6. Financial institutions and banks have embarked upon a significant shift in emphasis on price and speed rather than quality. One telling manifestation is the ignoring of Workplace Health and Safety obligations in respect of the safety of Valuers travelling to remote sites for the purpose of valuation. Constant pressure on turnaround times ignore the fact that the proper valuation of an asset (not only for the bank's protection in case of default, but more importantly for the consumers protection in terms of making decisions based on proper knowledge), is the most important part of the process.

The utilisation of AVM single valuation system is a point of failure

The valuation profession, along with many global professions and industries have been subject to technological innovation and disruption. The finance and banking sector has seen offerings by systems providers as an opportunity to reduce costs and outsource valuation and property market monitoring. The investor sector has sought more information on market prices to assist with a volatile property market.

Professional Valuers have experience, independence and work to standards and with methods that are transparent. Through long-term industry scrutiny they have been tested and their methods refined to produce accurate relevant and current results that take specific property features and local variability into account.

Valuation assessments produced solely from historical data cannot approach this level of currency and therefore relevance to immediate markets. Statistical estimations built on aggregate figures build in a bias often referred to as regression to the mean. The more historical data the system acquires, the more heavily weighted the assessments become to past pricing. Even knowing this regression bias, a system built on aggregate data cannot fully compensate for it. Furthermore, attempts to build in compensation factors for such volatility would be just as opaque to scrutiny as the main algorithms.

In a static market regression bias does not raise a significant issue. In a volatile market, one that is going up or going down, the regression bias will cause assessments to lag. If the changes are extremely rapid this will disadvantage consumers and institutions relying on those assessments.

The answer is not to exclude assessments based on models (although that has been the case in other sophisticated markets post financial collapse) but to insist the algorithms and weighting given by the calculations to different market variables are fully open to public and industry scrutiny.

The recommendation of the API is that the Commission examine the potential for procedural bias from AVM's and make suitable recommendations to protect consumers and the finance industry from the bias these systems may introduce.

Intellectual property

Intellectual property (IP) embedded in valuation and other property-related reports prepared by API members involves the acquisition and impartial analysis of property sales (and other) property-related data and other information which may possibly be confidential. It is directly procured by or provided to the financial institution as an important independent and expert piece of professional advice in order to appropriately guide risk-based lending decisions and determine asset value. As a matter of practice, when API members are engaged by banks and financial institutions, the IP in such valuations and/ or reports is commonly required to be passed to the client bank or financial institution.

Contractual requirements are imposed upon some API members when engaging with banks or financial institutions, wherein the IP embedded within the valuation report is required to be transferred. Many difficulties arise in the disclosure of some information including sensitive leases, confidential sales or other sensitive data, which when demanded by banks and overlaid with the clear power imbalance, Valuers yield in the threat of losing work

The various written and oral submissions received from API's members strongly suggest that the property data now held by the banks and financial institutions is utilised for purposes unknown to the API member whose IP in such data is now held by the banks or financial institutions. The API seeks clarity as to what purposes, having been obtained for a singular purpose, this IP is being used for. For example, is the IP is being commercialised by the banks without recompense, compensation or licensing fees to the Valuer?

Power relationship between Banks and Valuers

Clearly the negotiating capacity of the parties to an engagement contract between a bank and financial institution and an API member is quite different – one party to the contract has significantly more power in negotiating than the other. The API member must agree to the transfer of the intellectual property in the valuation or property report in order to secure the supply contract. API members are being forced to agree to do the work for much lower fees and more quickly, than can be reasonably expected.

API member submissions to our expert panel report that the inequality of negotiating power has placed API members in an ethical or adverse legal liability position.

Professional Indemnity Insurance

The view of the API is that API members, through their PI insurance have inappropriately underwritten for some time, the poor lending practices of financial services entities and cyclical changes in the property market. Internal connections in financial services entities between credit risk, property risk and procurement functional operations units obscure accountability and combined with ineffective communication lead to mistakes and reported 'stuff-ups'. Borrowers with a grievance because a loan did not proceed or a property was repossessed by a bank, or the property market simply corrected, are provided with limited information leaving Valuers as the only

source of redress and, who are then forced to rely on their PI insurance. In these instances, the Valuers concerned are known to rely on the lender for ongoing work.

The API submits that this situation has a significant flow on effect to the Australian economy, consumers and small business owners. PI premiums have already increased. Continued misuse by banks of Valuers' PI insurance could lead to the inability for Valuers (and other professionals) to obtain insurance in the Australian market which is seen as too small to service on a global scale currently, so additional disincentives could have a major and broader impact. This was significantly tested in 2011, with only one insurer left in the market out of London threatening to walk away from the Australian market.

Finance Brokers – severed relationship between Valuer and lender

The use of finance brokers as intermediaries between the banks and other financial institutions and prospective borrowers has led to a separation of the ultimate debt provider from the API members undertaking a mortgage valuation. Past prudent practice was that the prospective mortgagor would instruct the API member directly. This closer professional relationship meant that the API member had a direct point of contact permitting an early alerting of issues associated with the proposed loan where real estate and/or personal property was to form the security. The insertion of finance brokers into this process has created situations, of which the API has been made aware, where valuations are being disregarded, changed or pressure placed upon the Valuer to elicit a required value, so that the broker can secure the debt provision. Other markets such as New Zealand and the USA have created more distance between lender and borrower for this and many other prudent reasons.

Dilution of the value of valuations

Prior to the establishment of what we now call the valuation industry, bank managers took the risk of assessing the value of properties in their local area. The responsibility then moved to a professional contractor, the Valuer, together with the associated passing of risk. The intellectual property created from the valuation of a real property rested with the Valuer as creator. The Valuer passed to the bank a right to use this information for the purposes of creating a mortgage and to a large extent was held liable for its accuracy.

This system has allowed the bank to essentially pass the risk involved in the valuation on to the Valuer if the mortgagee defaults rather than the bank taking responsibility for its lending decision.

The volume and complexity of mortgages and the opportunity to create additional value in mortgage trading has given rise to another intermediate industry, mortgage broking. Mortgage brokers often act on behalf of banks and financial institutions and contract with Valuers for a valuation.

API members are concerned that financial institutions and banks are now able to control valuation information and valuation pricing. Ownership in valuation intellectual property has been wrested from Valuers. New entrants to the lending market are acting as agents for financial institutions and banks to demote Valuers and their capacity to maintain professional standards.

These arrangements have created barriers to professional practice for Valuers:

- Mortgage brokers have a clear conflict of interest in relation to the valuation. It is in their interest to raise the valuation to increase the potential for a mortgage and a sale. API

members report that it is not unusual for mortgage brokers to attempt to persuade the Valuer that the property represents higher value than the initial valuation. Depending on the long term financial relationship between the broker and the Valuer this can represent more or less pressure.

Mortgage brokers and banks have recognised that groups of valuations provide local and industry knowledge of market trends in pricing. In recent negotiations, it has been reported that banks and mortgage brokers have added a requirement for the 'exclusive' ownership of the valuation into the wording of the contracts. This essentially allows the bank or broker to receive and commercialise the Valuers intellectual property and to use the information for purposes counter to its original intent. With this ownership mortgage brokers or third party companies retained by mortgage brokers and banks create models of valuation and use these models for different purposes relating to risk, bundling and sale of mortgages. The US housing crisis is reported to have been precipitated by the manipulation of bundled mortgages in financial instruments.

AUSTRALIAN SMALL BUSINESS AND FAMILY OMBUDSMAN INITIATIVES

Government has sought to make valuation information prepared for mortgage purposes available to borrowers. This is contained in the Carnell Report at recommendation 8 and has subsequently been included in the recently released Australian Banking Association (ABA) industry guidelines developed in response to the Carnell inquiry and approved by ASIC on 31 July 2018. Banks that have adopted the guideline are expected to comply by 1 July 2019. This applies within the document at "Loans to small business" but there is a growing concern this will be applied to all banking customers. (See below at Term of Reference (j)).

Chapter 24 ABA Industry Guideline states:

"When using external property Valuers we will be fair and transparent

88. Our processes in relation to external expert valuations will be fair and transparent.

89. Our communication will be clear and we will explain the purpose of the valuation to the customer.

90. We will provide copies of property valuations and Valuer instructions (except when enforcement action has already commenced).

91. We will only appoint appropriately qualified and experienced Valuers who are members of professional organisations which abide by a similar code of practice."

The disclosure of valuation reports to borrowers is concerning for API's members because:

- It potentially extends a Valuer's duty of care to borrowers who may use and rely on the report for making decisions which are outside the purpose for which the report was prepared. The extension of the duty of care means borrowers (in addition to banks which are the direct client) could make claims of negligence and misrepresentation against Valuers. Valuers will have to show on a case by case basis that no such duty rises. The exposure of Valuers to another class of claimants will make PI insurers cautious. PI insurers may place further exclusions on Valuers limiting their coverage, or worse, stop insuring Valuers altogether.
- Valuations, particularly standard residential valuations which are prepared on PropertyPro templates, are not written to be understood easily by borrowers. There are multiple

documents which a borrower would need to be across in order to fully understand the advice in the valuation report, including the API's PropertyPro Supporting Memorandum and the ABFI's Standing Instructions.

API members applaud the underlying intention of this initiative in providing greater transparency, however, there are unintended consequences and broader serious ramifications. It is important that this be guided by appropriate regulation and professional protections. (See below at Term of Reference (j))

Better contractual terms between banks and Valuers and between banks and borrowers clearly setting out how valuations are to be used may limit spurious claims. The API believes that mandating such arrangements will require regulation and guarantee protections.

Recently, a national law firm partner, sent correspondence to a number of Valuation firm CEO's in which she makes reference to a struggling Queensland development that had been sold off the plan over two years ago and has settlements pending shortly. We have been given permission to provide this to the Commission as clear evidence of the need to reconsider, redraft and improve (or regulate and protect) the unintended consequences of the Carnell recommendation 8 and the ABA Banking Code of Practice.

The API considers that this correspondence, in fact, highlights the drastic and severe negative extent of the extension (beyond client) of a duty of care to third parties and which has been outlined within this Submission. This threatening and completely inappropriate correspondence, the API submits, demonstrates that the sharing of independent valuations to developers and potential property owners clearly impacts our profession, its members and, by extension, the ability to act independently. This is an important area where the Commission should focus attention.

It is attempting to hamper the Valuer's ability to act independently for their Bank client by:-

- calling into question the Valuer's methodology;
- Offering its preferred alternative method for valuing its clients development (both in theory and in the specifics of this matter), and
- without providing any particulars to the allegation the firm alleges that the valuation(s) were *'not competently prepared'* *'and raises the question of compliance with the API Code'*

This author states, inter alia, that *'In the event that the valuations which are not competently prepared continue to be provided for these apartments our client will have no choice but to consider taking further action'*. It is further stated that *'Our client reserves its rights, including its rights under the Valuers Registration Act 1992 (Qld).'*

The API considers that this firm and, indeed, their developer client, are setting a very dangerous precedent by explicitly threatening Valuers with legal action if they do not value in accordance with that developer's requirements. The property market is shifting nationally, with valuations coming in on average 20-40% less in some areas, and, at the higher end of the spectrum for lower quality stock.

This is a clear case for review of the Carnell recommendation and ABA Industry Guideline provisions extending the duty of care beyond the Valuers client and the issues and risks that each present.

The API sought legal advice on a number of recommendations from the Carnell Inquiry, and this advice is available here. [Review the Advice](#)

The flow on risk to PI insurance remaining competitive and available in this market is enormous which potentially has an extremely material impact on every API member, across the spectrum from small business owner to large corporation. The API underwriters have advised that they are currently looking at exclusions in policies in this regard and there is a very high risk that capacity for valuers in the Australian market will cease.

API RECOMMENDATIONS

Members suggested recommendations on structural issues

- Industry guidelines should be introduced on alternative valuation applications including limits based on the regulations introduced following the USA financial crisis and their subsequent regulation to remove the ability to use AVMs to secure real assets;
- External audits of internal valuations should be introduced with strict protocols, limits of value and/or loan-to valuation-ratio (LVR) where internal valuations may be appropriately conducted, and transparency to the consumer where an internal assessment has been used to determine the lending assessment;
- The API recommends an independent Alternative Dispute Resolution like Expert Panel and process to provide appropriate governance arrangements between financial institutions and valuation firms around disputes. There are many examples of financial institutions disputing valuations, forcing valuation firms to 'settle' where there is no proven misconduct, errors in methodology or negligence. Perhaps this Panel could also provide framework for assessing "fair and commensurate" fees for provision of Valuations;
- API Ethics or a similar course for brokers, property and finance industry professionals should be mandated to ensure consistent, high standard practices and quality assurance nationally;
- Industry standardisation of risk assessments at the local level should be introduced;
- Direct charge of valuation to the consumer (rather than being bundled with loan application fees) should be introduced ensuring independence of valuation and lessening market dominance by the banks;
- Protections of the intellectual property in valuations should be introduced including limits on the extent of disclosure of valuation to consumers;
- Clear process is required relating to claiming for loss through negligence; and
- Comprehensive education programs should be undertaken to explain how the proper valuation of an asset, and not a desktop estimate, is in the best interests of the customer, the consumer and the appropriate and effective functioning of the Australian property and financial markets.

Members suggested recommendations on removing barriers to professional valuation practice

The recommendation of the API is that the Commission examine the potential for procedural bias from automated valuation models and make suitable recommendations to protect consumers and the finance industry from bias these systems may introduce.

The API recommends that the Commission look into the timing of decisions by the major banks and financial institutions to require intellectual property in valuations to be legally handed to them.

In order to remedy and provide market-based compensation for the unpaid transfer of intellectual property from Valuers to banks and financial institutions and their service providers, our recommendation is that the Commission recommend the value of a 'valuation' be assessed independently in two components:

- simple access to the value statement and the components considered in the valuation, and
- purchase of intellectual property in the valuation as an exclusive right.

The API recommends that industry guidelines should be developed on alternative valuation applications and their limits, taking into particular account the experience from the United States' regulatory model removing AVM's to secure real property assets.

The API further recommends external independent reviews of internal financial services valuations and in particular both the models and loan-to-value ratio parameters set by banks and financial institutions where internal valuations are conducted, if at all.

The API recommends that the legal framework includes clarification that Valuers are excluded from claims if it is evident that:

- Valuers did not have control or oversight over additional valuation information used by the banks and financial institutions in assessing the loan parameters, and
- Valuers had no client relationship with the third-party, and
- Valuers did not engage in unconscionable conduct or fail to disclose matters that should have been disclosed to the borrower in respect of the loan.

The API believes that regulatory laws and policies ought to affirm and ensure the requirement and benefit of independent valuation advice for any class of asset, not just limited to land.

To be assured that the laws embrace the qualities that support fair and robust local markets they should include provisions that require:

- transparency over all models and the algorithms on which they are based;
- independence from the interests of stakeholders in the market,
- scrutiny by appropriate professionals,
- competition in pricing and supply if at all possible, and oversight of:
 - the internal systems of financial services entities; and
 - contractual arrangements to prevent unfair transfer of liability for claims.

The API considers the crucial role of the valuation profession is to provide a higher level of independent certainty for the capital framework of the Australian financial system.

The API believes there is a direct correlation between an imbalance in the key risk areas outlined above and areas of banking activity already examined by the Commission in financial incentives. Specifically the API believes that a willingness to 'bend' guidelines, policy and robust governance practices is also evident.

The API submits that the procurement of an independent valuation from an appropriately educated and qualified API member, who is subject to strict Professional Standards, Continuing Professional Development requirements and disciplinary action for non-compliance, is an important and prudent risk management mitigation.