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Real Estate Appraisal in Emerging Markets: Increasing Transparency and Investment

An interview with Bill Endsley
Director of International Relations
The Appraisal Institute

In his interview with CIPE, Bill Endsley of the Appraisal Institute discusses the important role that real estate appraisers can play in economic development and poverty reduction. Developing fair and transparent systems for the valuation of real estate, as well as raising awareness about international best practices in the field, are just two of the ways that the Appraisal Institute is addressing many of the issues found in emerging markets: corruption, a large informal sector, and a weak institutional environment. These efforts are helping to modernize the financial sector, which often results in increased investment and more efficient property markets.

The Appraisal Institute is a global membership association of professional real estate appraisers, with 22,000 members and 96 chapters throughout the world. Organized in 1932, its mission is to support and advance its members as the choice for real estate solutions and uphold professional credentials, standards of professional practice, and ethics consistent with the public good. On the international level, the Appraisal Institute is committed to developing the real estate valuation profession around the world and contributing to broader development objectives.

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CIPE: What is the role of real estate appraisers? How is their role different in emerging markets?

BILL ENDSLEY: I have had many heated discussions with highly qualified engineers from Cairo to Patagonia who could tell me within a few hundred dollars the cost to build a building. I point out to them that if no one wants to buy the building, lease space in the building, if there is an excess of this type of a property, if it is on or near contaminated land, or any number of other reasons, then the market value of the building may be significantly less than the cost to build. In many countries, I have passed empty concrete shells, abandoned buildings – even theme parks – that took advantage of a ready flow of capital, but not the basics of supply and demand.

This is where an appraiser comes in – to determine the market value of real estate. Obviously, in emerging markets, where market institutions are weak or underdeveloped, determining such a value is a much more challenging task. In emerging markets, you do not have access to the same data, predictability in transactions, contract enforcement, and property rights protection, among other things, as you get in more developed markets.

To summarize: an appraiser provides an independent opinion of the value of real estate. Both the independence of the appraiser – he must not advocate for either party to a transaction – and that an appraisal is an opinion, not an estimate or calculation of value, are essential to the definition.

In emerging markets, there is a tendency to view appraisal as more of a mathematical calculation, rather than the opinion of a trained and experienced property economics expert. This leads to an almost exclusive focus on the replacement cost method as the method of valuation. However, Generally Accepted Valuation Principles (GAVP) requires three approaches to value – the cost, market and income approaches. GAVP also requires that even the cost and income approaches be based on market information.

CIPE: What are the drivers behind the need for appraisers in developing countries? What are some of the issues appraisers face in emerging markets?

BILL ENDSLEY: There are two types of real estate investment – debt and equity. Debt investors participate in bond or mortgage markets and receive interest on their investment with the repayment of the loan. They will be looking for security in the form of a lien on real estate. Equity investors are owners of real estate assets and are compensated from the cash flows derived from the operation of the real estate and the appreciation of the value of real estate over time.

Competent, well-educated real estate appraisers are important to both debt and equity investors. Historically, debt investors have been the drivers in developing countries in the form of housing loans and bonds for infrastructure development. However, real estate is becoming a larger part of institutional investors' portfolios including corporate owners, major pension funds, and securitization vehicles such as real estate investment trusts. These investors are moving huge amounts of capital and are willing to accept a higher level of risk than debt investors in expectation of higher returns. This leads to additional opportunities for developing countries to attract this investment by nurturing a strong real estate valuation profession.

The most crucial real estate issues for developing countries are transparency and access to “uncooked” data. Investors are willing to accept risk as long as they can obtain enough information to price that risk. In many places, institutional infrastructure such as the licensing and certification of real estate valuers, rigorous and informed banking supervision, a supportive judiciary, and an efficient means for transferring liens on property held as collateral for mortgages, is non-existent. This leads to an opaque market where an outside investor cannot compare the relative risk of investing in one country over another. Even when these systems are in place, many times the processes are so time consuming and costly that investors stay away.

I recall speaking on a panel with an official from the Price Control Department of the Ministry of Finance of Vietnam. He spoke about how Vietnam needed the assistance to develop databases of property transactions. Someone in the audience asked, “Wait a minute, isn’t all the property owned by the government in Vietnam? Don’t you already have all the data?” He replied, “Yes, but it’s not market data. We are moving away from a centrally controlled economy and we need the assistance to help us develop a new system.”

CIPE: How does corruption have an impact on international real estate transactions?

BILLENSLEY: Corruption often takes a different form in developed and developing countries. For example, the U.S. Federal Bureau of Investigation estimates that mortgage fraud caused over \$1 billion in losses just in the U.S. in 2005. Mortgage fraud is an intentional misstatement, misrepresentation, or omission by an applicant or other interested party, relied upon by a lender to provide funding for, to purchase, or to issue a mortgage loan. Industry insiders usually perpetrate this type of fraud since it requires knowledge of the system. There is also growing concern that organized criminal elements may be using mortgage fraud to launder money, as other means of money laundering are facing more scrutiny.

One popular mortgage fraud scheme involves a ‘straw buyer.’ A company places an advertisement on the internet to recruit real estate ‘investment partners.’ The advertisement claims that the investment partners could earn \$7,000 if they assist in one mortgage loan transaction and up to \$18,000 to assist in four transactions. To receive the money, the investment partners merely need to qualify for property loans, with no financial obligations or mortgage industry experience required.

The company then locates an investment property, purchases it in the straw buyer’s name, and transfers it into a land trust. The property would then be leased to generate money for mortgage payments and not remain in the straw buyer’s name for more than two years.

In reality, the perpetrators of this type of fraud – real estate brokers, mortgage brokers, and appraisers – buy a property for a low price, resell it to the straw buyer for a highly inflated price, and pocket the difference. They then disappear, leaving the straw buyer with a mortgage that he cannot afford. The loan goes into foreclosure and the bank discovers that because of the fraudulent appraisal, the asset is not worth nearly enough to pay off the loan.

While such direct fraud and corruption, including bribery and influence peddling, also take place in the developing world, we have found that entrenched “gatekeepers” are a major corruption problem in countries that try to address fraud and move into international markets. Such gatekeepers can be internal bank valuers without sufficient independence from lending decisions; overly cautious government officials with no understanding of real estate economics who refuse to permit any bank to make mortgage loans; or real estate professors.

In one developing country, for example, we built a working relationship with a professor at a university. We sent 5,000 program brochures and workbooks to her to promote our program. When we went to the country to award certificates to students who had completed the program, we found the majority of the brochures in an office closet. She had personally distributed the program documents only to people she knew and would allow in the program.

In another country, a professor with government connections was able to get only his course approved for government licensing of valuers. He had additional stipulations written into the licensing law that allowed him to control who got a license.

These professors had the best of intentions, but their actions limited the number of financial intermediaries available to support transactions. Therefore, mortgage markets are still severely limited in those countries.

CIPE: What about the issue of the informal sector? How does it affect what you do around the world?

BILL ENDSLEY: The informal sector is a much bigger problem in emerging markets. Since properties are not part of the formal system, governments cannot use taxes from these properties to generate revenue for infrastructure projects such as roads, access to clean water, schools, and health care facilities. In turn, citizens cannot use these assets as collateral for loans to improve their homes or start small businesses.

In our work in Egypt, we found that a high rate of unregistered properties leads to limited access to real estate-backed credit by households and small- and micro-credit enterprises. This is due to the high costs and other obstacles to the registering and titling of property, a system for registration and execution of liens, and the absence of standardized consumer protection.

This, in turn, leads to the absence of real estate financing institutions and the standards necessary to promote the private construction of new housing. Thus, there is an extreme problem with inadequate housing stock. In addition, cultural norms that discourage the selling of homes and the disclosure of information, a narrow range of financial instruments available to borrowers, and a lack of trust in financial sector institutions provide additional roadblocks to developing a robust and transparent housing system.

We are working in Egypt to develop a fair and transparent system for the valuation of residential real estate as a first step in financial sector modernization. If citizens can understand the true market value of their real estate assets and be certain that everyone is being evaluated by the same measure; if the high cost and complex procedures for registering properties can be reduced and simplified; if the benefits of a formal system can be proven; if access to credit can be provided at reduced rates, with lower down payments and longer terms, then people will begin to move into the formal sector.

CIPE: When operating in weak institutional environments, what measures do local associations, affiliated with the Appraisal Institute, take to ensure high standards of integrity?

BILL ENDSLEY: There are highly qualified, well-trained, and ethical real property economic professionals available in every part of the world. Many times these professionals are associated with universities, banks, resource institutions such as gas and oil companies, or other major building and asset owners. Although they may work in less formal systems, they are arbitrators in the transactions that occur. Many times they “know by their nose” because of their experience and understanding of the local market, whether it be for an oil and gas tanker facility in Azerbaijan or a village market in Zimbabwe.

Our process has been to seek out and engage these professionals with the help of funding from development agencies and begin a cooperative process where we learn what systems are in place and look forward to a convergence point where their system will move toward international norms. This takes sustained engagement over many years. Our program in China started in 1994 and the first training courses were not offered until December 2005.

In every instance, it has been essential to find one key individual who has the commitment and connections to act as a champion and shepherd a program through the inevitable obstacles, mistakes, and opposition. These visionary individuals look beyond the profit motive and know that ultimately efficient property markets are the real solution for long-term economic development.

CIPE: Focusing on the broader issue of ethics and development – how do you see organizations such as yours contributing to development of countries and lifting people out of poverty? What more can be done?

BILL ENDSLEY: ‘Highest and best use’ is one of the fundamental concepts of Generally Accepted Valuation Principals. While this term has a specific meaning in the real estate valuation process, the highest and best use of resources including land, property rights, institutional infrastructures, and people are crucial to bringing emerging countries into global property markets and raising the standard of living for those

in low and middle income countries. These concepts may be of little use in extreme poverty situations, but they are essential to the development of a middle class that can provide stability to an emerging economy.

More needs to be done to develop world citizens – individuals who both expand the geographic scope of their business activities and knowledge and increase their understanding of how markets are interrelated. Good world citizens look out for their neighbors, take action against criminal elements, and participate in multinational organizations with the awareness that their contributions are essential to an increasingly flat world where the empowered individual is the new catalyst for change.

In this regard, the Appraisal Institute is fully committed to developing the international real estate valuation profession and contributing to broader development objectives. We look forward to working with a broad range of civil society organizations and development agencies to move the development agenda forward.

William E. Endsley is the director of international relations for the Appraisal Institute. He has a Bachelor of Arts degree in communications from the University of Memphis and has overseen the international programs of the Appraisal Institute for the past seven years.

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initiatives in over 100 developing countries, involving the private sector in policy advocacy and institutional reform, improving governance, and building understanding of market-based democratic systems. CIPE provides management assistance, practical experience, and financial support to local organizations to strengthen their capacity to implement democratic and economic reforms. CIPE programs are also supported through the United States Agency for International Development.