



Vereniging van
Institutionele Beleggers
in Vastgoed Nederland

FRAUD RISK MANAGEMENT
in the institutional property sector
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FRAUD RISK MANAGEMENT IN THE INSTITUTIONAL PROPERTY SECTOR

1. Foreword

On 13 November 2007 it emerged that the FIOD-ECD (Fiscal Intelligence and Investigation Service and Economic Investigation Service) is carrying out a fraud investigation into property transactions, involving current and former employees of institutional property investors. Just as everyone else in the institutional property sector, the management of the Association of Institutional Property Investors in the Netherlands (hereinafter referred to as IVBN) was very shocked. The suspects are strongly suspected of collusion to commit fraud. Although the suspects' guilt still has to be established, these suspicions alone affect the sector to its very core.

In this memorandum, IVBN, as sector association for the institutional property investment sector, will discuss the control measures used by professional parties in our sector to limit fraud and its potential financial consequences. These offers company boards, shareholders and internal and external supervisory bodies of property investment companies the opportunity to learn from them and make adjustments in their own organization where necessary.

IVBN believes that the professional parties in the institutional property investment sector have incorporated sufficient control measures in their organizations to minimize the risk of fraud. This applies at any rate to the structure and existence of these measures; their effect must naturally be continually evaluated. It must be ensured that, based on these current investigations into individuals and the pressure of publicity, politicians do not impose stricter frameworks or legal measures too hastily.

This memorandum, primarily intended for the institutional property sector, is an initial step. Partly on this basis, IVBN, together with other parties involved in the institutional property investment sector such as developers, valuers and estate agents, but also civil-law notaries, the Land Registry, the ROZ/IPD Property Index and RICS, will continue to explore the possibilities for reducing the risk of fraud even further. In addition to the consultations that members of IVBN naturally hold with their own boards and supervisory bodies, IVBN will hold discussions with the sector organizations of the pension funds (Dutch Association of Industry-Wide Pension Funds (VB) and the Association of Company Pension Funds (OPF) and the insurers (Dutch Association of Insurers).

Paragraph 2 discusses the vulnerability of property to fraud. Paragraph 3 goes on to consider the governance and culture of the organization (including schemes for both the management and personnel). Paragraph 4 then deals with the general control framework of property companies and in paragraph 5 the specific control framework in relation to acquisition and disposition. Paragraph 6 gives an explanation of the valuation policy and structuring of purchase and sale transactions. Finally, in the last paragraph we will discuss the environment of the institutional property investment sector: with which parties do institutional property investors already collaborate to reduce the risks of fraud, and which measures could be developed further in this area.

The following overviews, incidentally, do not form a checklist in order to ‘tick all the boxes’. After all, every institutional investor has to form its own judgment on which of the control measures referred to would be useful and applicable compared to the risks that are run in that specific organization and context. Each control measure in itself does not cover every situation. A combination of control measures are needed to offer as effective protection as possible against fraud for that specific organization and those specific transactions. This will usually be a combination of firm measures (procedures such as due diligence, external valuations) and soft measures (e.g. increasing the awareness of fraud).

The control measures referred to above depend partly on the level at which the final decisions are made within or outside the organization. Sometimes this is done by the board (whether or not up to a maximized amount), the supervisory board, investment committees or a pension fund board, etc. In this overview we will refer to this as the relevant decision-making body. The choice of control measures also depends on the size of the organization. With a smaller organization, a separation of duties is not possible everywhere. A smaller organization will have to take compensatory control measures to limit these additional risks, whereas the internal and external supervisory bodies will have to be extra critical and alert.

It is important to acknowledge that the activities relating to purchases and sales by institutional property investors form part of the entire property value chain (from initiative for building and operation, ultimately to redevelopment or demolition). IVBN will limit itself at this stage to acquisitions and dispositions; the other processes will also be described in further detail at a later stage.

This memorandum was drawn up by a Supervisory Task Force set up by IVBN (for the task force’s composition, see appendix), consisting of a range of disciplines such as acquisition/disposition, risk management, compliance, legal matters, finance/accounting and control. The management of IVBN is very grateful to the task force for its contribution to the compilation of this overview.

2. Vulnerability of property to fraud

The general model for fraud is not specific to property. Fraud can arise through:

- Opportunity
- Pressure
- Rationalization

Opportunity

Property has a number of characteristics that make it vulnerable to fraud. Firstly, the lack of a market quotation leads to less transparency. Establishing a property's value by means of external valuations is one of the measures that can be used to counter this. One should remember, however, that valuations do not lead to a precise figure, and this certainly applies to less marketable properties. Valuations made by different valuers may also differ from each other. Secondly, the capital intensity of property transactions is so great that relatively small differences from a purely arm's-length transaction may have considerable consequences in an absolute sense. And thirdly, the property market (owners and advisers) is readily accessible to all kinds of parties, including less professional and honest ones.

Pressure

Pressure can be divided into business and personal pressure. Examples of business pressure are investment pressure, achieving targets etc. Examples of personal pressure are greed, jealousy, lifestyle, etc.

Rationalization

Parties must be aware of the risks where there are great differences in the position of individual negotiating parties (a speculative property developer versus a government official, for example, or a wealthy property trader versus a person involved in dispositions at an investor). The difference in the remuneration of individuals involved in a property transaction can also be considerable. This increases the rationalization of fraudulent practices and therefore the tendency to 'justify' fraud.

IVBN has a Code of Ethics with which its members must comply. Most members have their own code or own business principles, which have usually been developed into all kinds of rules of conduct or regulations. Imposing even more rules, however, is not a feasible solution, because the system must also remain workable. Companies cannot rely too much on hierarchy and rules in order to guide the conduct of their employees. The consequence could be that people in fact feel less responsible for their conduct, and will at the very most feel responsible for their own strict compliance with the rules.

Control measures against fraud begin and end with the personal integrity of individuals in the organization. A simple rule of thumb is that if employees cannot or dare not speak with each other about events, behaviour or gifts given or received, for example, something must be wrong. Not only must there be a proper scheme for reporting this, but something must also be done about the culture of the organization.

3. Governance and culture of the organization

This paragraph discusses the structure and management, and above all the culture of the organization. The control measures are categorized as preventive, detective and reactive, with some measures having both a preventive and detective effect.

Preventive:

- 'Tone at the top': the exemplary function of the board is extremely important
- Organization of sufficient size with professionals
- Established strategy, operationalized in the investment policy
- Code of conduct for ethical actions (or the Model IVBN Code of Conduct or a company's own, more far-reaching, scheme); also an insider scheme (lays down whether or not individuals themselves may deal in property, or be personally involved in the organization's activities); but also how to deal with 'Chinese walls' within the organization and a policy in respect of ancillary positions
- Policy on gifts (also to business contacts) and invitations (both giving and receiving them)
- Policy on the standards that must be met by parties with whom transactions are made, and based on which screening is carried out (customer due diligence)
- Information/training/annual updating of the codes of conduct and other measures to increase awareness among employees of vulnerability to fraud and confidential information
- 'Pre-employment screening' for employees, the depth of the screening depending on the nature of the position
- Policy on bonus schemes, including elements of short-term and long-term results and financial and non-financial criteria

Detective:

- Supervision by the supervisory board, management board or client, and external audit by an accountant, whereby some or all of the persons involved must have knowledge of the property market
- Risk management established and embedded in the organization as part of business operations. The potential risks are periodically surveyed and evaluated
- Decision-making based on decision documents and minutes
- The existing codes of conduct must be assessed by both the line management and the compliance officer
- Accessibility of information across all departments
- Transparency in reporting, including financial reporting
- 'During employment screening' for employees, the depth of the screening depending on the nature of the position

Reactive:

- Incident management and whistleblower scheme for reporting incidents within the organization
- Policy on fraud investigations; how to act when possible fraud is detected and engaging investigation agencies by order of the employer or cooperating with investigating government and semi-government authorities

4. General control framework

This paragraph examines the general control framework of property companies which aims to limit as much as possible the risk of fraud and its potential financial consequences.

Preventive:

- Separation of duties (i.e. application of the 'two pairs of eyes' principle) e.g. between initiation, decision-making, implementation, recording and monitoring)
- Decision preparation by several disciplines, besides the asset or portfolio manager, technical manager and acquisitions manager, also by the research, tax/legal, administration and controlling departments
- Any deviation from the rules to be properly reasoned and documented; the latter applies in particular to the decision for that deviation by the relevant decision-making body

Detective:

- Process descriptions of the critical processes (based on risk assessments) (such as with SAS 70 or SOX), containing decision-making, accountability and recording; also the internal control structure; including a regular assessment of their existence and operation, therefore also including periodic external audits
- Awareness of the role and the business and personal interests of parties and individuals involved in the transactions
- Analysis of the difference between the fund's results and the ROZ/IPD benchmark
- Valuation policy: annual external valuations
- Compliance with IVBN recommendations for the annual reporting, these are initially intended for external reports, but can also be used for reports by parties who only need to make an internal report as a part of a larger whole
- Documentation and file review
- Rotation of employees across portfolios and clients

5. Specific control framework: acquisition and disposition

This paragraph discusses the specific control framework in respect of acquisition and disposition. Acquisition and disposition of property are central processes for a property investor and must be well structured and managed in order to minimize the risks of fraud. The control measures that function with acquisition are to some extent comparable to those with disposition. Here too, a distinction is made between preventive, detective and reactive aspects.

5.1 Acquisition

Preventive:

- Policy must formulate which specific markets and products the fund is interested in, and which it is therefore not interested in (assessment framework must be manageable as well as determined and recorded in advance)
- Financial criteria with which an acquisition must comply are clear and updated according to a fixed method (and awareness of the sensitivity of the input variables on the outcome)
- Internal valuation model for acquisitions is firmly established with fixed formulas and with starting points that correspond to the acquisition criteria
- Separation of duties (two pairs of eyes principle) between
 - a) deal sourcing / negotiations
 - b) assessing market conformity of rents and yields (research)
 - c) opinion on desirability of the property and the forecast cash flows (portfolio management)
 - d) contractual records (company lawyer)
 - e) financial records (F&A)
 - f) subsequent calculation (controller)
 - g) investment decision (decision-making body)
- Screening / Customer Due Diligence (CDD) of contracting parties, intermediaries and the Ultimate Beneficial Owner (UBO), in order to conclude transactions only with reputable parties; this involves the company's own market knowledge, own longlists and shortlists, consulting available sources (Commercial Register at the Chamber of Commerce, Internet Google) and/or having a targeted investigation into the contracting parties carried out by specialist agencies,
- Phased decision-making from initiative to investment

Detective:

- Check property history in the land register: as well as checking property details, also which owners and other transaction details, extra attention to be given to them if an ABC transaction was involved
- Recording the entire transaction and the property details in an investment proposal for approval by the relevant decision-making body
- New builds and existing properties to be assessed against the schedule of requirements of the investor concerned
- Contractual recording by company lawyer (or under his direction by an external lawyer)
- Regular subsequent calculations of properties bought based on external valuations and operating results, including feedback to decision-making body and officials involved in the transaction

5.2 Disposition

Preventive:

- Periodic screening (hold-sell analysis) whether the properties in the portfolio still comply with the general policy principles and return and risk criteria
- Discuss results of hold-sell analyses in a broader management context
- Screening / Customer Due Diligence (CDD) of contracting parties, intermediaries and the Ultimate Beneficial Owner (UBO) in order to conclude transactions only with reputable parties
- Include an anti-speculation clause, subject to a penalty

Detective:

- Disposition proposals including sales strategy are drawn up by the portfolio management with the underlying calculations and reasons why the property no longer complies
- Approval of disposition proposal is in accordance with the investment proposal. Process the same as that for acquisitions
- Contractual recording by company lawyer (or under his direction by an external lawyer)

As stated at the beginning of this paragraph, most control measures taken at the time of acquisition will also occur with the disposition process. With both acquisition and disposition of individual properties, portfolios or parts of portfolios, it is important how the purchase or sale process and the pricing are structured. The following paragraph will deal with this.

6. Further explanation of valuation policy and structuring of purchase and sale transactions

This paragraph gives an explanation of both the valuation policy and the possible structuring of purchase and sale transactions. The valuation process in particular is explained in greater detail in relation to acquisitions and dispositions.

Valuation policy

A sound valuation policy is an important guarantee for dispositions and acquisitions being made in conformity with market standards. Valuation is a separate process, but has important areas of overlap with acquisitions and dispositions as well as testing the conformity of these transactions with market standards (ex-ante and ex-post). A sound valuation policy comprises:

- Annual external valuation (full valuation, revaluation or update) according to a predetermined schedule, based on a written order confirmation including the valuation principles to be used
- External valuers rotate regularly around another part of the portfolio, and regular change of external valuer
- External valuations (of a part of the portfolio) are managed by and for an officer other than the one who is directly responsible for the properties to be valued
- Co-assessment of the valuation report by research and portfolio management
- Feedback of valuations by the external valuer to a broader circle of officers involved

Structuring of purchase and sale transactions

There are various options for structuring purchase and sale processes, and the selling party chooses, depending on the situation, one of these forms:

- By private treaty (one-to-one)
- By private treaty, e.g. select three parties and give them the opportunity to give a price indication, then continue further with one of the three
- Tendering in a single phase (irrevocable and unconditional offer), with or without preselection of candidates
- Tendering in two phases (first conditionally / indicative, then proceeding with a smaller group towards an unconditional/irrevocable offer), with or without preselection

The choice of procedure to be followed must be documented, this applies in particular to transactions by private treaty. What is also important is for the sales procedure to be followed in a transparent manner from beginning to end. Tendering without preselection is less desirable. After all, only transactions will be aimed for with reputable parties. Engaging a civil-law notary in these processes will contribute to a transparent process, pricing and awarding of the tender. If a tender process is nevertheless followed without preselection, naturally conditions will be set beforehand, on the basis of which the ultimate award will be given; and then the remaining candidate or candidates will be screened too (albeit late in the process).

If enough bidding parties are expected, a sale by tender is often a good way to find a more than willing buyer, and by doing so to maximize the sale result. If only a small number of bidding parties is expected (e.g. with properties with redevelopment potential or vacant properties) a transaction by private treaty will usually be the method chosen.

With a tender in two phases, IVBN believes that, from the point of view of transparency for all the parties involved, the preferred option is to engage the civil-law notary in the bidding process.

With the sale of homes, incidentally, the IVBN Code of Conduct specifically applies to IVBN members with the sale of residential properties and complexes, in which specific conditions are imposed on the new owner on continuing to be a good landlord or (where individual units are sold off) a careful process of individual sale to sitting tenants.

7. Relationship with the environment

The institutional property investment sector in the Netherlands forms part of a chain with all kinds of other parties, and operates in an international market. That is why it is important for IVBN to enter into dialogue with relevant parties to minimize the risk of fraud and promote personal integrity. IVBN has begun discussions on this with parties who are operationally involved in property, including institutional property, such as the ROZ/IPD, valuers, civil-law notaries (KNB) and the Land Registry. Discussions with other groups such as estate agents and other relevant sector associations are still to follow. This paragraph also describes the other relevant parties and the main subjects of discussion.

A number of parties have already made suggestions for extra measures to minimize the risks of fraud. It is important here to make a distinction between the various potential fraud cases that occur in different segments of the property market. For example, there are currently potential fraud cases to do with domestic and foreign property partnerships and commercial partnerships, while in Rotterdam there is fraud in relation to residential property and mortgages. IVBN assesses the suggestions already made according to the contribution they would make to preventing fraud in the institutional sector.

Valuers

The great importance of valuations (and with them the role of the ROZ/IPD) has already been discussed in this memorandum. The value of the property in the portfolio of an institutional property investor is appraised by means of valuations, since a valuation forms the reference for the market value. Valuers for an institutional investor within the context of the ROZ/IPD Property Index must work according to the ROZ/IPD guidelines. The valuation process must be properly structured and the starting points for the valuation must be made known in advance, as also the model to be used on which the valuer bases the initial yield and market rental values. The large agencies have already been asked what recommendations external valuers could still make to achieve further quality improvements and a tightening up of valuation procedures in order to minimize the risk of fraud even further. Discussions on this will be pursued with external valuers.

ROZ/IPD Property Index

Virtually all institutional property investors, under the umbrella of IVBN, participate in the ROZ/IPD Property Index. The ROZ/IPD is an internationally based (IPD) benchmark, which was set up in 1995. The results of the annual benchmark are published in March each year. The ROZ/IPD Property Index uses strict guidelines for both internal and external valuations and monitors the quality of valuations, such as by assessing the valuation information against market prices (before calculating the index) and a random check of valuation reports. Discussions are regularly held between IVBN and the ROZ/IPD. IVBN attaches great value to a further professionalization of the valuation process that the ROZ/IPD Property Index aims to achieve in consultation with external valuers. IVBN is in favour of participants and the office of the ROZ/IPD making maximum use of confidentially obtained information within the ROZ/IPD database at an aggregated level, also - where possible – to prevent fraud, particularly valuation fraud. After all, the great strength of the ROZ/IPD is the very large database with information on institutional property.

Subjects of discussion between IVBN and the de ROZ/IPD:

- Reduction of differences in value definitions that still exist
- Greater uniformity of definitions (also in an international context; including the RICS standards)
- Greater uniformity of methods and techniques
- Tightening up of valuation guidelines
- Checks on provision of information by participants
- Tighter checks among participants against the benchmark
- Increase the periodic checks on the contents of valuations

Civil-law notaries / Royal Notarial Association (KNB)

The civil-law notary fulfils a crucial role in the transaction process. The KNB may impose guidelines and rules on the notarial profession, while the Financial Supervision Office ensures its integrity. The KNB is involved in discussions with the Land Registry, the Ministry of Justice and Parliament on possible changes in the law that would limit the risk of property fraud and make it even easier for the competent authorities to investigate fraud.

Subjects of discussion between IVBN and KNB:

- There are discussions between the Land Registry and the KNB on reducing the periods of time and updating information, so that the Land Registry files to be viewed by the civil-law notary will be accessible faster (virtually real-time).
- At the end of December 2007 the KNB announced that payments by civil-law notaries to third parties may only continue to be made to a modest extent.
- The KNB has already published guidelines for ABC transactions, which incidentally usually take place in a perfectly legitimate way. IVBN recommends a greater knowledge of these guidelines among all parties who are professionally involved in property transactions.
- In order for investigative authorities to detect fraud better, the suggestion has been put forward in the media to abolish the transfer tax exemption with ABC transactions, and to replace it with settlement through the Tax and Customs Administration. This would be instead of mutual settlement through the civil-law notary. With ABC transactions, however, the transfer tax payable can already be effectively followed by the Tax and Customs Administration. IVBN therefore sees no reason to make any changes in this area.
- In November 2007 the Rotterdam report '*De Fraude Voorbij*' ('Fraud, a thing of the past') was published, containing proposals for an integrated approach to property and mortgage fraud in relation to residential property. These proposals, however, are of little use in preventing fraud in the professional sector.
- The KNB supports making it compulsory for the sales contract to be drawn up by the civil-law notary. There would appear to be a parliamentary majority for this as far as residential property in the consumer market is concerned. IVBN believes that professional and expert parties in the property sector must still be able to draw up the sales contracts themselves.

Land Registry

Subjects of discussion between IVBN and the Land Registry:

The Land Registry provides very good facilities for conducting searches in the land register into the history of the property. The fact that this is possible must be better publicized.

- The Land Registry has made two recommendations concerning limiting the risk of fraud in property, whereby naturally the Rotterdam property and mortgage fraud in relation to residential property has played a major role. The Land Registry recommends making all information on residential property public. This may possibly make a contribution in the consumer housing market. According to IVBN, the publication of this information will have little significance for the time being for the professional property sector, particularly commercial property, since value definitions used in the market often vary considerably from the basis for valuation in residential property, whereas the way in which a valuation of residential property is made cannot be compared with a ROZ/IPD valuation, for example.
- The Land Registry has argued in the media for having sales contracts included in the Land Register, in order to obtain openness in the case of ABC transactions about the intermediate party B. Here too, this may make a contribution to the consumer housing market. IVBN is in favour of greater transparency with ABC transactions, but that can also be achieved in other ways by enhancing the role of the civil-law notary. IVBN wants to hold further discussions about this with the KNB and the Land Registry.

Estate agents (discussions yet to be held)

Possible subjects of discussion:

- Parties to whom estate agents provide services must be known to them and screened for their integrity
- IVBN wants to enter into discussions with estate agents on the system of brokerage fees and commission and greater transparency therein, in order to minimize the potential risk of fraudulent activities
- Clients for the sale of a property provide the estate agent or agents acting on their behalf with a written selling instruction, and the brokerage fee will be agreed on in advance

Other relevant associations

RICS (Royal Institute of Chartered Surveyors)

One of the objectives of RICS in the Netherlands is to promote the personal integrity of property professionals in the Netherlands. IVBN and RICS wish to develop this further.

ROZ Real Estate Council of the Netherlands

IVBN, Aedes, Vastgoed Belang, the Association of (Prospective) Homeowners (*Vereniging Eigen Huis* - VEH), the Association of Apartment Owners (*VvE Belang*), the Netherlands Association of Property Developers and Investors (NEPROM), the Netherlands Association of Builders and Developers (NVB), two estate agents associations (NVM and VBO), the Association of Registered Valuers (RVT) and the Royal Notarial Association (KNB) are all represented in the ROZ.

Within the ROZ, IVBN has drawn attention to the various fraud cases currently in the news and has proposed that the parties take joint action in these cases; there is a clear role for IVBN and NEPROM, together with the KNB and the valuers, to play in the matter of potential fraud at an institutional investor and a developer.

NEPROM / NVB

NEPROM will analyse how professional property developers interpret guidelines and procedures in relation to internal monitoring of possible fraudulent activity and guaranteeing personal integrity.

Private property sector (partnerships and commercial partnerships)

A number of potential fraud cases involving a few domestic and foreign partnerships and commercial partnerships are currently being investigated by the Public Prosecution Service. The Netherlands Authority for the Financial Markets (AFM) has already published a warning report on partnerships and commercial partnerships. The Dutch legislator has decided that commercial partnerships in property, with participations exceeding € 50,000, should not be obliged to obtain a licence. In the view of IVBN this threshold is too low, and recommends that the Dutch legislator raise this threshold to € 250,000. The AFM's policy aims to promote professionalism and self-regulation from within the sector of commercial partnerships in property. This self-regulation is already beginning to take shape through the Foundation for the Transparency of Property Funds (*Stichting Transparantie Vastgoedfondsen*) and the Association of Property Funds (*Vereniging van Vastgoed Fondsen*).

Appendix Composition of the IVBN supervisory task force

Chairman: R.J.M. Hogenboom MRICS
Chairman of IVBN, Managing Director of Altera Vastgoed

Secretary: F.J.W. van Blokland MRICS
Director of IVBN

Members: G.J. Iemhoff RC
Senior Controller BPF Bouwinvest

J. Gaasenbeek MRE MRICS
Director of Portfolio Management Delta Lloyd Vastgoed

J.W. Hekkenberg
Head of Operational Risk Management ING Real Estate

C.J.M. van den Hoogen RA MRE
Financial Director of Altera Vastgoed

G.F. van Hooydonk MRICS
Head of Real Estate Mn Services

F.J. Pickkers, LL.M.
Head of Legal Affairs (previously also compliance officer) Syntrus Achmea Vastgoed

A.W. Rozendaal
Financial Director of Bouwfonds Asset Management