

House Price Valuation and Understanding the Impact of Conflicting Measures

By Stephen Connolly

Introduction

The recent volatility in house prices has impacted many areas of the credit industry, but none more so than the mortgage lenders themselves. With the value of the asset underlying the loan no longer monotonically increasing as it did in the pre-Crunch years, lenders are seeing this volatility translate into significant movements in expected loss. Property values are an absolutely critical consideration for this sector and the recent movements have been the most dramatic for many years.

This situation is exacerbated by the fact that knowing the true value of a property can be very difficult. A full valuation is usually only available at origination and lenders need to extrapolate that through time to understand the value of the asset now. Many lenders use an indexing driven by one of the standard house price metrics to adjust house prices based on the broad changes in the market. However, the recent downturn has highlighted the issues inherent in this approach, from the inconsistencies in the measures themselves to the fact that these are blunt tools capturing high-level trends and as such will not work for every property.

One Version of the Truth?

As the economic recovery remains slow, the recent history of UK house prices movements remain a source of concern. The standard house price measures are in a continuous state of flux, with contradictory messages being fed back to the markets every month. The fear of a double dip recession remains omnipresent as the market dynamics shift once more.

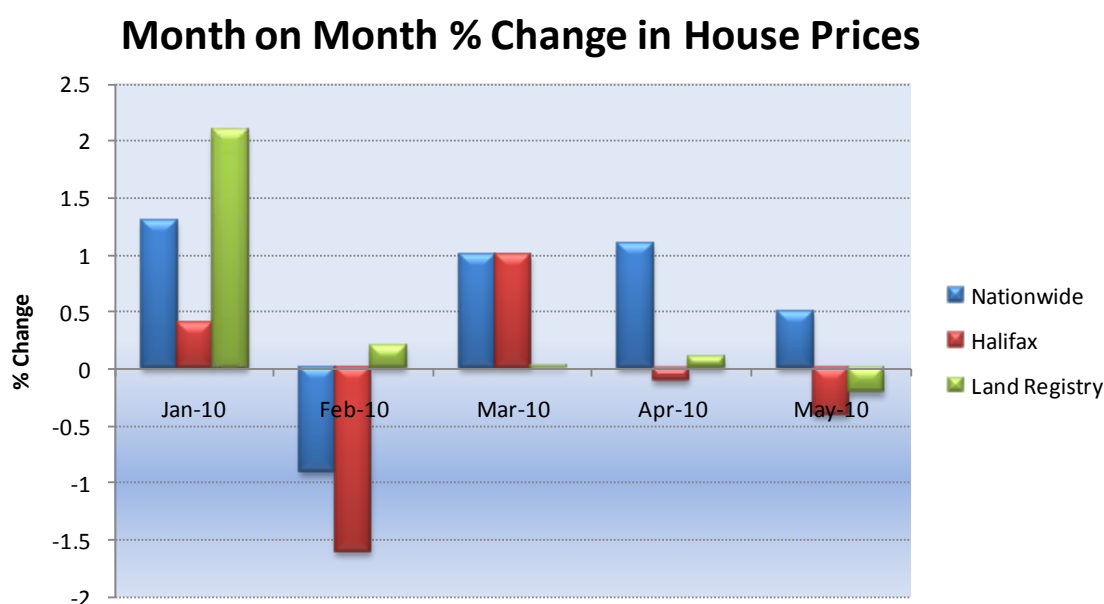
The possibility of higher interest rates and the rush of sellers to beat the budget changes in Capital Gains Tax has increased the competition amongst sellers and reduced the number of potential buyers. The situation has been exacerbated following the scrapping of the controversial home information packs. It's becoming a buyer's market but buyers are being cautious in this time of austerity.

For the month of May the Land Registry has reported that house prices in England and Wales fell by 0.2 per cent month-on-month. Previously we have seen from the same measure an increase

of 0.2 per cent in April and a drop of 0.1 per cent in March. In simple terms the market remains relatively frozen.

To complicate the discussion further, the Halifax Price Index reported a 0.4% fall in house prices for May while for the same period the Nationwide Building Society estimated a 0.5% rise. The divergence in indexes continues from the previous month where the Nationwide estimated a 1.1% increase as opposed to the Halifax index which reported 0.1% drop in April. While many commentators are quick to point out that the divergence is mainly driven by low transaction levels, it does raise the question of how reliable can any house price measure be during the current recession, particularly now at the threshold of another swing in the market dynamics.

To illustrate the divergence in indexes the following chart demonstrates the month on month % change in the top three UK house price indexes.



As the volatility in UK house prices has increased, so too has the level of inconsistency between the three main house price indices. At a time when lenders need to be more certain than ever about house values, they are seeing a less and less clear picture emerging from the market.

Pitfalls and Problems

Given the above, it is imperative that lenders understand the limitations of any house price indexing approach used on their own portfolio: Is the business over reliant on a single index? Are there segments of the book that are particularly prone to valuation error? What is the level of

confidence that can be attributed to the current valuations? These considerations are important as an accurate and unbiased valuation is essential for:

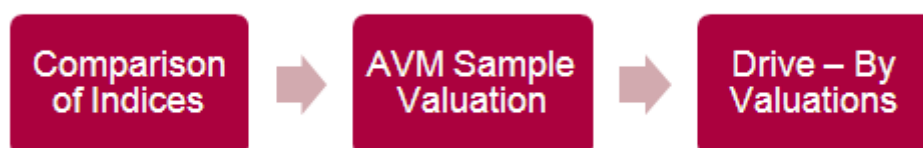
- Future business planning
- Provisioning
- Retention activities
- Managing arrears and recoveries
- Decisions on how to deal with fraud
- Decisions to sell part of a portfolio

If lenders do not have a true view of their mortgage book there may be large segments of the portfolio which are overvalued, giving a skewed and misleading view of risk. Similarly if properties are undervalued then this may lead to sub-optimal customer management strategies. In all cases, incorrect calculation of property price will make it harder to manage the portfolio sensibly and carefully.

A huge number of factors can cause a valuation based on an indexing approach to be incorrect, nearly all of which stem from the fact that house price indices are, by their very definition, averaged measures. Geographical region is one such consideration, with price movements varying across different areas even when these are close to each other. The most obvious example would be the Greater London Area – the highest and most diverse concentration of properties in the UK. Prices in one area may be falling while others stay static for example, making a broad valuation approach misleading and potentially damaging. Similarly, the property type can be a driver for price movement differences, with small flats changing price at very different rates to large, executive houses.

Identifying the Issues - A Best Practice Approach

Euristix have undertaken extensive research in this area and have successfully engaged with a number of clients to apply a comprehensive valuation strategy deriving a more granular understanding of house price movements and portfolio performance. We advocate a three tier process:





This methodology has been developed to identify hotspots where valuations differ across indices and test the accuracy of the current view. Where an extreme difference exists between the AVM estimates and the current valuations, Drive – By¹ valuations have been utilised to remove the uncertainty. While such a process will not be feasible for every lender, the result of this is a true understanding of how the portfolio looks during these changing times.

The Euristix Approach

Comparison of Indices

The first step is to understand the impact of any divergence in the indices on portfolio valuations. By comparing the results of using different standard indices in the valuation calculations, including regional versions where suitable, it is possible to understand the scope of the variability. It is also possible to assess whether the incumbent approach is more or less conservative than valuations under other measures, and to decide what might be most suitable for the business.

AVM Valuations

Using AVM valuations on a sensibly constructed sample of accounts can yield insight into valuation discrepancies on key segments. Measuring the discrepancy between AVM valuations and their index-driven counterparts can identify areas of reduced accuracy. It can also assist in determining which index appears to be most appropriate for use on certain types of accounts. The sample used in the AVM analysis should be determined in relation to the risk profile of accounts to help identify 'problem' pockets of accounts where the valuation inaccuracy is high. The uncomfortable truth is that index linked valuations can be least accurate on precisely those accounts that carry the highest risk.

Drive – By Valuations

Where the nature of the accounts warrants the additional expenditure and effort, Drive-By valuations can be used to provide real clarity on the accuracy of index and AVM valuations. The insight from the surveyors can enable a lender to refine the use of indices on certain areas of the portfolio and develop the most appropriate valuation approach in these cases.

Using this Knowledge

This analysis highlights for lenders the detailed composition of their portfolio and the concentration risk resulting from overvalued segments of the book. It also exposes areas of concern, where the original valuation may have been overstated for example, and will reinforce

¹ Drive - By valuations are unique in that a surveyor will value a property from a list of attributes and an external inspection only.



the need to consider a more granular approach to valuing properties in the Greater London Area. The Drive-By inspections may also expose localised areas where the quality of properties may be far below expectation.

Of course understanding the areas of valuation risk and the size of the issue is only the first step. Armed with this knowledge, lenders can ensure that they produce valuation schemes that are most suitable to their portfolios and the risk profile. In many cases, it may simply be a matter of choosing the most appropriate index to use within a given segment. Another alternative is to use a blended approach which makes use of multiple house price indices to give a robust view. For high risk segments or for accounts on which key actions are required it may prove prudent to make use of periodic AVM valuations or other tools which give greater confidence and granularity in the valuation area. It is only through understanding the volatility and risks inherent in the current valuation process that well-founded decisions can be made.

In this climate, increased analytical sophistication will become a key strategic advantage. A business that has detailed information, together with analytics based business planning will have a clear opportunity to mitigate future losses. Overvaluing a property or subsequently failing to utilise an accurate valuation to drive actions are two of the most significant risks any lender can face. One thing seems certain, the economic recovery will be much slower than was previously expected and as more customers get into trouble mitigating losses and risk management strategies will heavily rely on an accurate and unbiased house price valuation.

For more information about this article or how Euristix could help you in this area please contact Stephen Connolly at stephen.connolly@euristix.com