

Use of AVMs in a falling market

Although many people believe that 2008 will see a declining residential property market, there is no reason why AVM accuracy will be negatively affected, explains **James Neave**, Director of AVM Performance at UKV



Towards the latter part of 2007, the leading house price indices were indicating property price reductions across many parts of the country. Whether this trend will continue through 2008 remains to be seen, but nevertheless it has raised a pertinent question for AVM users: can they continue to trust AVM valuations in a declining market? This market briefing explains why we believe AVMs can continue to be relied upon - even when house prices are falling.

Objectivity

One of the key benefits of an AVM is objectivity. This objectivity applies not just to the way in which the valuation is statistically derived, but also to the way in which the AVM tracks house price trends.

The UKValuation AVM tracks the market using several hundred different indices which correspond to specific property types in specific localities. These indices are the starting point which allow the AVM to *objectively* track the market trends in a consistent manner - regardless of whether the market is trending up or down.

Recency of data

Data for the AVM is fused from many sources, including the Ordnance Survey, CACI ACORN data, Royal Mail, Land Registry, surveyors, and mortgage lenders. It is data from these last two sources which is most important for ensuring timely updates to the house price indices, and this data is received on a monthly basis. This therefore introduces approximately a 1-month lag into the process. However, this issue is not specific to AVMs – a time-lag is built into *all* of the leading indices including those from Halifax, Nationwide, DCLG, and Land Registry. This means that there are several further points to consider.

Firstly, even a surveyor's valuation will rely on comparables. When surveyors are required to index these comparables over a period of time the question arises: using which index? And, are these indices consistently applied? Secondly, accepting that no index can ever be completely up-to-date, a surveyor will make

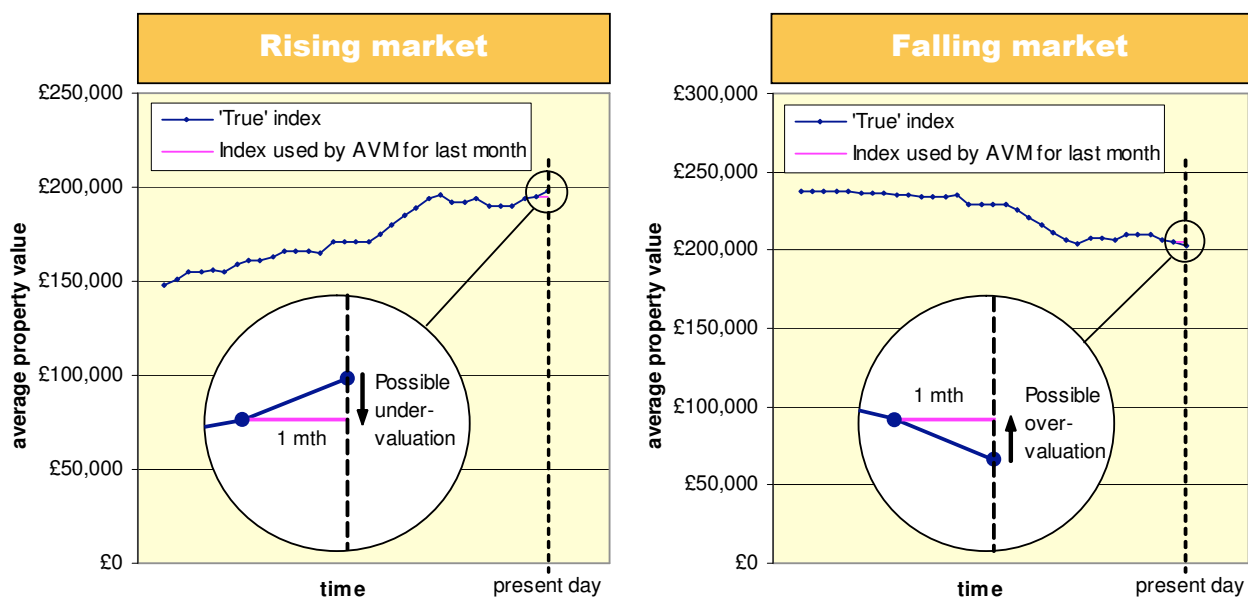
Executive Summary

- AVM house price indices treat appreciating and depreciating markets identically
- Due to the nature of the data sources there is a data time-lag of approximately one month
- In a falling market this lag can lead to a consistent overvaluation but the effect is both small and quantifiable
- The maximum size of potential overvaluation can be accurately estimated at just over 1.5%, which is not significant compared to the natural volatility associated with any form of valuation
- Overall, the analysis shows that a falling market will not significantly affect AVM accuracy and therefore we recommend that AVM criteria do not need to be restricted for this reason

subjective adjustments based on their understanding of market conditions. The AVM will not attempt to do this and will instead assume a flat price trend from the last known data points. Both approaches have their strengths and limitations, but it goes without saying that the application of subjective adjustments or forecasts by surveyors can create challenges from a risk perspective regarding their basis and consistency.

The time-lag effect

The two charts below explain why the time-lag effect can lead to both small under- and overvaluations.



The effect arises from the fact that the AVM implicitly makes the assumption that the index remains flat until there is hard data available to determine the direction of the market.

Quantifiable impact

As can be seen from the scale of the graphs above, the effects of the lag are very small. Critically, they are also quantifiable. The size of the lag can be estimated several ways:

1. If house prices increase or decrease by 20% pa, that equates to a compound monthly change of 1.5% - hence a monthly lag should be no more than this.
2. Between Feb-2004 and Oct-2006 (a period of prolonged market growth in the UK) the largest observed undervaluation of UKValuation test portfolios was just 0.5%
3. Parts of the US have now experience a sustained period of market decline and so they are uniquely placed to analyse the impact on AVM accuracy. A recent study¹ by UKValuation's parent company (*First American CoreLogic*) demonstrated that in regions with fast-falling house prices, a maximum overvaluation of 1.7% was recorded in the second and third quarters of 2007.

It can therefore be surmised that, unless truly exceptional market conditions occur, the time-lag effect will account for between 1.5-2% maximum error either way, in the worst case. This market-dependent, consistent bias is not significant when viewed against the natural variation in individual property valuations (which is observed regardless of whether the valuation is derived from an AVM or a surveyor).

¹ *Challenging the Conventional Wisdom* by Robert L. Walker, Executive VP, Collateral Solutions, FACL – Dec 2007. Please contact james.neave@ukvaluation.co.uk if you would like to see a full copy of this report.

Summary and Conclusion

AVMs are able to respond to both rising and declining markets and, although the time-lag effect can create small, consistent over- or under-valuations (depending on the market conditions), these variances are very small when compared with the natural variations associated with individual property valuations. Furthermore, the average over- or under-valuation of the AVM resulting from market trends is highly quantifiable, and this is in contrast with the potential variability associated with surveyor valuations in volatile markets – especially in such times when there is a degree of uncertainty about the future direction of the market. The market can never know with certainty where prices will move next, and different surveyors from different companies will all have their own interpretations of the prevailing market conditions. The AVM side-steps the problem by accepting the time-lag and only making price adjustments once sufficient data has become available.

In conclusion, we can state that a declining market does not significantly impact on AVM accuracy. This leads us to recommend that there is no need for mortgage lenders to restrict AVM-specific lending policy rules or criteria in the current market environment.

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About UK Valuation Ltd

UKValuation is a subsidiary of First American Corporation. Core to the services we provide is our powerful, innovative Automated Valuation Model (AVM) and our unique property database which is used to deliver real time computer-generated valuations of residential properties. Clients include blue-chip financial services providers across the UK mortgage market.

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About First American CoreLogic

First American CoreLogic, a member of The First American Corporation (NYSE:FAF) family of companies, was formed through the merger of First American Real Estate Solutions, America's largest provider of advanced property and ownership information, analytics and services, and CoreLogic, the leading provider of residential mortgage risk management and fraud protection technology and services. The combined companies' databases cover more than 3,000 counties, representing 99.1 percent of the United States population. With more than 600,000 users nationwide, First American CoreLogic products are used by businesses to improve customer acquisition and retention, detect and prevent fraud, improve mortgage transaction cycle time and cost efficiency, measure the value of residential and commercial properties, identify real estate trends and neighborhood characteristics, track market performance and increase market share. More information about First American CoreLogic can be found at www.facorelogic.com.