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Comparison between Valuations based on Automated Valuation Models (AVMs) and on Indices

1. Quality and Method of Valuations

Under the current regime no methods are prescribed on which the valuation should be based. The aim of valuation is to get as precise an idea as possible about the value of collateral at that particular point in time in order to assess the financial risk/assets etc. The more accurate and reliable this valuation is the greater is the transparency and thus the resilience required by the regulator as set out in the single rulebook.

1.1. Potential Problems with Index-based Valuations

Traditionally the vast majority of revaluations of residential properties is carried out by using national indices available in each of the EU 28 jurisdictions such as those provided by the respective national offices of statistics. There are, however, indisputable and demonstrable disadvantages in an index-based revaluation, which include:

- An index is merely an average house price development for a large regional area; as a result smaller regions within this area can show a vastly different house price developments compared to the average that the index suggests.
- An index requires a previous property valuation; as a result therefore the bias und inaccuracies included in this previous evaluation, which in the worst case may even include fraudulent intent or excessive optimism that might have been present in the valuation at origination, will be carried forward in an index based valuation
- An indexed valuation has no reliability indicator or Confidence Level, and thus lacks a predictive measure expressing the estimated accuracy of each valuation. This is of particular importance when valuing unique or non-standard properties since these are much harder to value than standard properties and would potentially results in a low Confidence Level. This, however, is very important information for any user of the valuations in terms of risk assessment and an indication of how much trust they can place in the valuation itself.

As a result index based valuations at origination or at any point of revaluation of residential properties or entire property portfolios are prone to carry a high degree of uncertainty and bias. Thus the resulting valuations of collateral and thus the review of the quality of assets and potential financial risks of a financial institution may in many cases not give the transparent and accurate picture intended by the single rulebook.

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1.2. Advantage of Automated Valuation Models (AVMs)

In recent years the use of Automated Valuation Models (AVMs) in the valuation process of residential property as collateral has emerged in a number of European countries and has led to accurate, transparent, unbiased and independent valuation process, which in the EAA's view vastly improves the data quality and the determination of the actual value of collateral, thus leading to a better functioning and efficiency of markets. These AVMs are now increasingly used by banks and other stakeholders within the mortgage and real estate industries, especially for valuing entire property portfolios.

The EAA holds thus that the use of AVMs for the valuation of the collateral of residential properties should be recommended or even made compulsory as an alternative to the current index-based approach. AVMs provide a value estimate for any given property using sophisticated mathematical modelling techniques in an automated and, hence, entirely objective manner. An AVM is a uniquely valuable tool for risk managers who need to accurately monitor and update the market value of residential property portfolios for credit risk mitigation and regulatory compliance, and to provide an indication of value for investors and consumers or to update the market value of the underlying collateral within structured finance products such as RMBS and Covered Bonds.

An AVM has the following advantages vis-á-vis an index-based approach:

- An AVM does not require a previous property value as input and thus does not carry forward any bias, fraud or excessive optimism that might have been present in the original valuations
- An AVM is able to value properties where no previous transaction is known to the party requiring the valuation, thus making up for any missing data within the mortgage book
- An AVM is demonstrably more accurate and therefore more reliable than the traditional portfolio revaluation methodology through indices; this can be shown a simple and scientific manner in extensive empirical tests conducted on large data samples from, e.g. Italian residential property portfolios
- An AVM includes a Confidence Level for each valuation result, thus providing risk managers with an indication of accuracy at a property-by-property level and allowing them to achieve much greater granularity in their models than with any other approach. Unique or non-standard properties are harder to value than standard properties, which would result in a low Confidence Level. This is important information to the user of these valuations, as in how much confidence they can place in the valuations itself
- Confidence Levels also form the basis of the Rating Agencies' published treatment of AVMs, resulting in much lower "haircuts" than those applied to indexation.