Regulatory change is about to have an impact on the measurement of house prices, says Troy Martin of Acadametrics. Move aside name awareness and free publicity, and welcome to meaningful data concerning the state of health of the UK's largest asset class

World of the house price index is about to change

In our July article 'Homing in on the true measure of house price inflation in the UK' we discussed the national obsession with house prices and the confusion caused by the monthly publication of a variety of prices which, all too frequently, are in direct contradiction, one with another.

Although these prices are different because they represent different measures, they are, nevertheless, treated as comparable by the press. The measures are different because each index is produced for a specific purpose and a specific audience, with a specific use in mind, and each is based upon different data. Lenders use their mortgage offer prices and estate agents their asking or survey prices. In both cases, the data are representative only of the samples used and may or may not also represent the market as a whole.

The construction and validity of house price indices is an arcane subject and it is not surprising that it is one of which much of the press appears to be in blissful ignorance. But how many professional users understand the basis upon which prices are calculated? Our not-so-shocking conclusion is that the accuracy of house prices indices has not, to date, much mattered to the lending industry. The competitiveness, let alone survival, of a business has not hung upon the accuracy of house price measures.

Regulatory change is about to have an impact on the measurement of house prices. Move aside name awareness, fed by column inches of publicity – the house price index world is about to change.

Indices for just about everything are now almost everywhere. This abundance is driven by the increasingly sophisticated techniques employed in the financial markets and by the ever-growing demand for investment, hedges and derivatives. We will discuss how these will affect house price indices in a future article. For now, the bell has tolled for the use of house price indices purely as a marketing tool, rung by the regulators wielding Basel II legislation.

Lenders may use indices to revalue their loan portfolios and calculate capital requirements. The 18 June note from the Financial Services Authority's Credit Risk Policy team to the Credit Risk Standing Group makes it clear that the choice of index is down to the lender. The note states, apropos "any property valuation, whether that value is at origination or as a result of revaluation", that "firms need to be satisfied that the valuation used for capital purposes is prudent (at or below market price) at exposure level (refer to BIPRU 3.4.69), and that this can be demonstrated. The valuations must be overseen and signed off by a valuer who is independent from the credit decision making process. In principle, we are not ruling out the use of statistical indices as a tool for revaluing residential property for firms on the standardised approach as long as the limitations of this approach are properly accounted for".

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Where does this statement place the lender indices – the traditional cost-free alternative to automated valuation models and surveyor revaluations? These indices were not designed for revaluation purposes and how it could be demonstrated that their use would be prudent is far from apparent. Nevertheless, the fact is that they are, as a rule, hard-coded into lender systems and it seemed to us that it should not be beyond the wit of man to devise a simple solution. Measuring index accuracy was already a significant element in our development work for the FT House Price Index.

Our index was aimed at accuracy. In developing our valuation series from the index, we were aware that revaluation

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accuracy would need statistical quantification. Working with Dr Steve Satchell at Cambridge University, we developed a series of upper and lower confidence limits around a valuation at property type/location cell. In simplistic terms, we did this by comparing indexed sales values with actual sales values achieved. We used the results of this analysis within our off site scenario and stress testing programmes during 2006.

Is our revaluation series, based upon the FT House Price Index, the only choice for lenders? The answer is no. Lenders wishing to continue using their hard-coded traditional indices may continue to do so. Late in 2006, we embarked upon a programme to prepare confidence limits for every single UK house price index. This work, which is nearing completion, allows us to calculate a confidence limit regardless of the index being used, or of its granularity.

Our work means lenders do not have to be concerned with the accuracy of their chosen index or of their indexed revaluation but, by using our analysis, can create a meaningful and statistically robust revaluation range within which to work. Chief surveyors will be able to discern where they should use AVMs or where they should require a full appraisal, providing both operational and risk efficiencies within a regulatory compliant and sound methodology – exactly what the Basel doctor ordered.

Having a means whereby every major index can be used for indexed revaluation, we foresee that lenders may start to use alternative indices. We foresee a new series of opportunities, regarding value and risk, opening up soon for lenders.

This brings us back to investment markets, derivatives and hedges. In our next article, we will pursue recent developments in the US using the Case Schiller indices, and will show how UK markets look set to develop quickly, based upon indices that are transparent and use publicly available data. These developments may be a step too far for some of the traditional indices, but may suit some of the new boys on the block, such as the FT House Price Index.