Defensive Appraising in a Declining Market

By John Lifflander, ASA

As market conditions continue to decline, appraising has become more difficult and potentially perilous. Consequently, it has never been more imperative for appraisers to prepare reports in a way that will hold up to meticulous scrutiny.

Properties that are selling or being refinanced now may well be in distress in the next few years or even the next few months. This could cause an increase in litigation against appraisers, as lenders seek to find ways to recoup their losses. If a property is taken back by a lender or sold as a short sale and the appraisal is found to be flawed, a lawsuit may be filed against the appraiser and/or the appraiser's insurance company. This article offers strategies that can help insulate you from liability.

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Understanding the New Market

Before analyzing how appraisers can appraise defensively, it is important to understand that the mindset of many appraisers needs to change. Because of the upsurge in real estate activity in recent years, many newer appraisers have never valued property in a declining market. Some are unaware of the risks of appraising in current market conditions and do not comprehend the fact that there are things to consider in a declining market which are not particularly important in an increasing market. It is also important to realize that inflated appraisals in an increasing market may not surface as long as the market keeps increasing—there is no reason for lenders to analyze them if there are no losses. However, in a decreasing market, inflated values are more obvious—in other words, in a declining market there is less room for error.

In January 2006, a survey taken by the *National Association of Realtors* showed that over 40 percent of the new owners who responded bought homes with no money down (*Down Payments' Downward Trend*, Washington Post, January 21, 2006). A century ago, banks required buyers to have at least a 20–25 percent down payment and decades ago, most loans required at least 10 percent, with the exception of VA and FHA loans. The point is that many buyers have no vested financial interest in keeping their homes as the values decrease and they cannot make their payments (although there are credit complications). To put it in a more common vernacular, many have "no skin in the game." Appraisers need to understand that for this reason and many others, this debacle is not going to end soon. And the longer these adverse conditions continue, the more important it becomes for appraisers to adapt to new market realities– their professional future depends on it.

Checking "Declining Market" Box

Many appraisers are loathe to check the "declining market" box for a number of reasons. If they do, many lenders require more work on the appraisal without additional compensation. Lenders may want more comparables or newer ones,

John Lifflander, ASA, is a Certified General Appraiser in Washington and Oregon and is president of Covenant Consultants, Inc., an appraisal and property tax consulting firm. He teaches appraisal courses and has been published numerous times, and is the author of Fundamentals of Industrial Valuation, a textbook for industrial appraisers published by IAAO (International Association of Assessing Officers). He is a former administrative law judge for property tax appeals for the Oregon Department of Revenue and specializes in providing expert witness testimony and consultation for complex valuation litigation. He can be reached at john@liffland.com.

in addition to active listings and gridding, and adjusting these require a considerable amount of work. In addition, lenders often want detailed evidence that the market is declining and some appraisers are not certain of how to prepare a report to prove it. Also, since some lenders will not lend in a declining market, loan officers and others may attempt to pressure the appraiser to indicate the market as "stable."

Nevertheless, if the appraiser chooses "stable" instead of "declining" and the market is declining, a door may have been opened to a significant lawsuit if the house is resold at a loss by the lender in the future. Even if the value is accurate, the lender can claim that it relied on that information to make the loan. And if enough evidence is provided to show that the appraiser should have known of the decline, this may constitute a prima facie case, which means that "on the face of it" or "by first appearance," there is a serious error in the appraisal.

Appraisers can document a declining market using various methods. A search can be made for properties that have sold twice in the last year or so, with the second sale at a lower price. These will be particularly common with short sale properties. Most multiple listing services have this historical information. Articles in the local newspaper from authoritative sources can also be used as backup evidence. Multiple listing services often offer information but appraisers need to be careful using it, since sometimes there is statistical manipulation to make the market look better than it is. For instance, using only the median sale price may not be a true reflection of the market, since the median price can increase while property values are decreasing, especially in certain value ranges or neighborhoods.

The history of the listing prices of the sales comparables may also serve as backup evidence, although it cannot be conclusive because the property may have been overpriced to begin with. For instance, a comparable may have been listed at $400,000 in December, reduced to $380,000 in February, then to $350,000 in March, and finally sold for $320,000 in April. One sale alone may not be considered good evidence but if all three comparables show a similar history of list price reductions, and listings are also provided which have been reduced over an extended time period, this information will buttress the appraiser's contention. Generally once an addendum is prepared with this type of information it can be used for the same general geographic locations and needs to be updated from time to time only.

Timeliness of Sales

The expression, "time is of the essence," is of paramount importance in relation to comparable sales in today's market. Appraisers are finding that the market is in a constant state of flux and that sales that have sold six months ago may not be indicative of current values. For this reason, many lenders are now requiring one or two comparable sales that have closed within three months. However, even three months may be too old in many circumstances. For instance, in one market an appraiser found recent sales that proved a value of $380,000 for a particular house. However, after he checked current listings, he found several homes in the same subdivision with the same plan with asking prices around $360,000. He had to revise his estimate taking this into consideration, and use time adjustments according to the percentage of decline for the sales.

Remember that most offers are made at least one month before the closing date, so that time period should also be considered in adjustments. Often the MLS shows when the property became a pending sale, which helps pinpoint the time period. Appraisers who use older sales when newer ones are available are appraising unethically and should also consider the legal implications if the property becomes distressed. It is relatively easy for another appraiser or investigator to go back and research sales, and if better ones exist, the appraiser will have a difficult time explaining why they were not used. Using older sales when more current ones exist is similar to going a further distance for comparable sales when closer ones exist– it is a "red flag" to a reviewer that the value may have been inflated.

As previously mentioned, it is important to examine listings in a declining market. The lowest listing prices represent the highest value the subject might sell for, and if adjustments are made, a listing to sale price adjustment should be estimated based on the ratio of similar sales. In other words, if properties are generally selling for 95 percent of the sale price, the appraiser should adjust the listings accordingly. Remember, however, that many sellers still have unrealistic expectations, therefore many listings may be quite high compared to the actual value, and there may be none that represent the true market value. Nevertheless, to ignore listings in a declining market could be construed as incompetence and be used against the appraiser if there is litigation.

Using Short Sales

Short sales are not foreclosure sales but they are sales which have some duress involved. In short sales the owner often owes more on the home than it is worth, and is generally behind on the payments. (This is also often referred to as being "upside down" in the property.) The lender, hoping to avoid the expense and time involved in a foreclosure, allows the owner to list the property, with the condition that the lender can approve the sale price. The agreement may relieve the owner from an obligation to pay for the loss, or it may

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leave the owner open to a deficiency judgment, depending on the agreement. In contrast, a true foreclosure sale is one that is generally auctioned off at the courthouse steps, and the buyer has to produce a cashier's check for the full amount to purchase it.

Since short sales are advertised in the MLS just like any other sale, they affect the market much more than foreclosure sales, which are available only to those who have cash and the time to research the properties they want to buy. The research is important because buyers can purchase a second trust deed instead of a first trust deed by mistake if they do not know the lien history.

However, there is no extra effort needed to buy a short sale and any real estate agent can show a short sale property along with normal listings. So should an appraiser use short sales as comparables in an appraisal? If they are common, many believe they should be included because they have become the market. Some argue that they may be in substandard condition but if this is the case, adjustments can be made just as they would be for any other sale. If the appraiser decides not to include short sales, it is highly recommended that they be noted in the appraisal with an explanation as to why they were not used. Otherwise, the appraiser will be open to charges of negligence for not informing the lender that they exist. Short sales may also be a predictor of where the market is going, for once buyers see the latest short sale prices, they often do not want to pay more.

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Concessions

Concessions essentially add "thin air" to the value of a property. They generally inflate prices by an average of two to three percent. Nevertheless, many real estate agents are still writing up offers with concessions and expect the appraiser to "bring in the value" regardless of the new market realities. Recently an appraiser told an agent that the sale price of a certain property, which included $10,000 in concessions, also constituted market evidence against the sale– in other words, the true market value was minus the concessions. The agent asked why and the appraiser said that no seller would have a reason to sell for $10,000 below market in an arm's length transaction. The agent did not agree and said there would be many reasons but could not name one. Appraisers need to also realize that many comparable sales may have concessions, which will inflate the value of the property under valuation. Often it is worth a call to agents to ask if there were concessions, but not all agents are forthcoming and often appraisers will get two different answers after contacting the buying and selling agents.

Conclusion

Appraising in a declining market requires a greater depth of understanding and attention to market changes than appraisers have had to exercise in appreciating markets. Listings take on much greater significance, as does the timeliness of comparable sales. Appraisers need to renew their thinking as they analyze market evidence because the danger of litigation looms greater in this market. If there are any indicators that could prove a lower value, no matter how minor, they should be disclosed with a detailed explanation as to why there were not utilized. It is not worth risking one's license and livelihood over one appraisal, nor is it worth risking litigation that may drag on and cause stress and unhappiness. Remember, all it takes is one over-valuation or perceived over-valuation to cause trouble. WRE