COVER STORY

# Foreclosure—

## The Looming Threat to Property Values

**By John Lifflander**

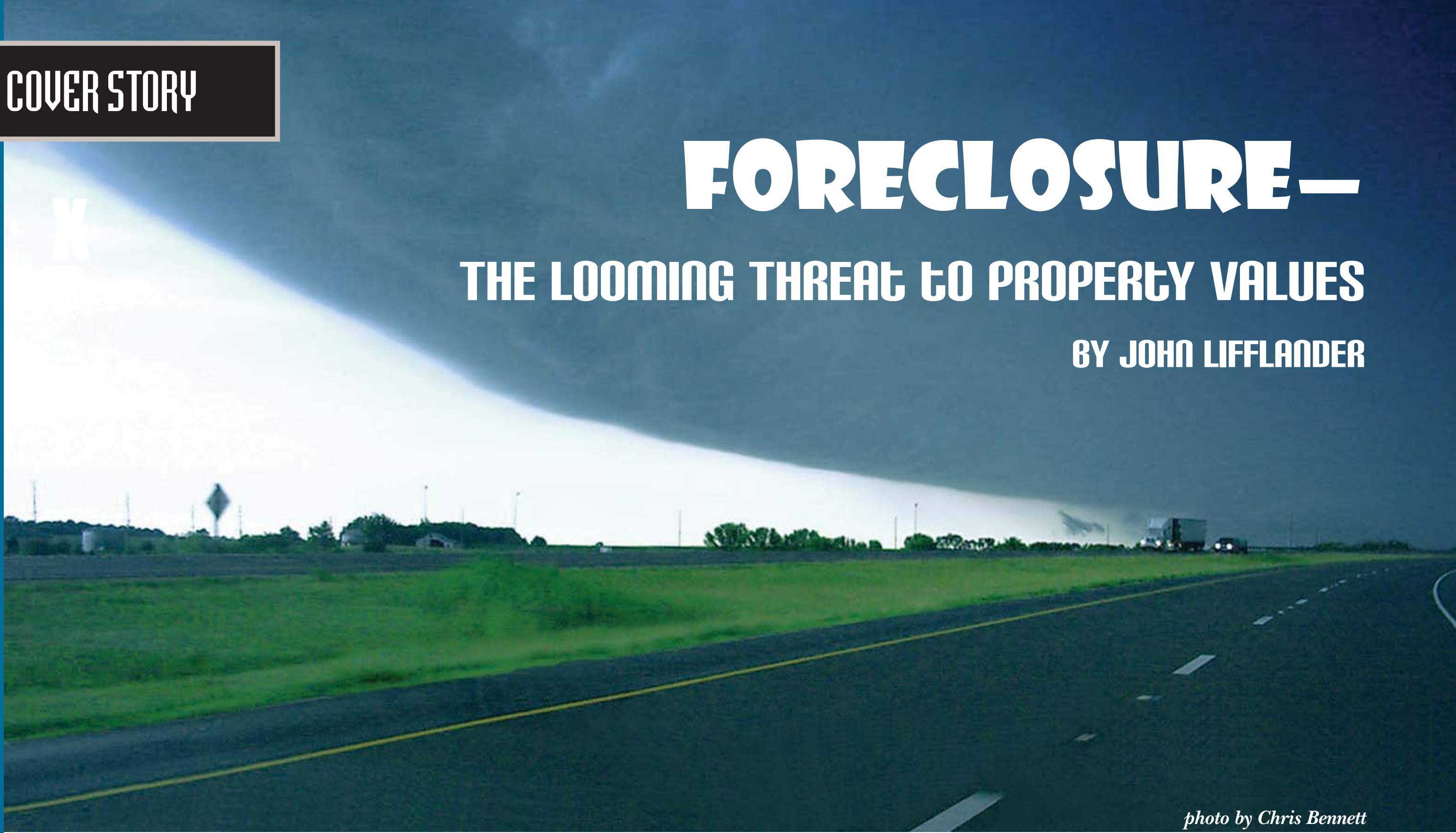

*photo by Chris Bennett*

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One of the consequences of what is becoming a real estate crash in many locations, is the difficulty it is causing in some assessor's offices. In many cases, appeals have multiplied, and values appear to be more diverse than ever before. Also, the lag time between the tax bill's arrival and the property's valuation date has worked against many assessors to make it appear that they are not "on top" of the market.

Reassessment has become more difficult in this market environment. Those with the task of determining new values often find themselves with the conundrum of which sales to use and which to discard. Sales prices for similar properties are covering ever widening ranges or, as some might say they are "all over the board." This has caused even the most experienced government and fee appraisers to step back to make certain their valuations are accurate.

Lenders are also concerned and are asking for much more information from appraisers than ever before as real estate, once considered perhaps the safest investment one can make, has become fraught with risk. No one is certain when the market will bottom out, as prices continue dropping in many areas, and new revelations of fraud and incompetence in corporate real estate lending continue to surface.

### New Complexities for Mass Appraisal

The current problems in the real estate market complicate mass appraisal Regression analysis is increasingly difficult to utilize when the sales data used to determine values has become heterogeneous due to differing characteristics. The situation can be compared to the appraisal of high-value homes which are difficult to value en masse because their amenities can vary greatly. One luxury home may have special stone exteriors, while another has an elaborate boat house and dock, or marble floors, or a host of other expensive features. These properties require individual scrutiny by an appraiser to determine an appropriate value which can take an inordinate amount of time and put a burden on assessors' resources.

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In a similar way, the circumstances of the sale of properties require special scrutiny when market conditions are changing drastically and continue to be in a state of flux. Unlike the differences in luxury homes, the homes may be very similar—they may even be "cookie cutters" in the same subdivision, but the task of valuing them becomes exceedingly complex because the sale prices vary greatly. The current real estate market, which is declining in most of the United States as well as in many other countries, has placed assessors in this predicament. Its resolution will require a new degree of appraisal expertise and an analysis of how the circumstances of sales should be considered in determining market value.

### The Looming Question

With the specter of declining values comes the critical question of what sales assessors should use to determine market value. Typically, state statutes guide ad valorem practices used to arrive at market values. These statutes are often supplemented by administrative rules that further define which sale circumstances can be included in market value calculations. Sales selection can have a marked effect on the results. If sales have been made with "undue stimulus" or under some type of duress, they may not be considered valid for sales comparison purposes. At some point, however, sales that involved some type of stimulus may be the only properties selling, or they may comprise the majority of sales. Then, stimulus-driven sales have essentially become the market. When this happens, assessors, whose overriding directive is to appraise properties at their market value, may need to consider including these sales.

This type of analysis is always open to debate. Some would argue that only transactions without a hint of pressure should be used. This position might be hard to explain to homeowners, however, when their neighborhood contains listings for similar properties with asking prices that are lower than their assessed values. These taxpayers may well challenge the assessor to explain how they could get more for their houses should they decide to sell than repossessed properties being liquidated by lending institutions or homes nearing foreclosure being offered subject to short-sale approvals.

### The Circumstances of the Sales

A true foreclosure sale represents one extreme on the continuum of sales that include an element of duress. In many locations, a foreclosure sales are auctioned off "on the courthouse steps." Buyers of these types of properties usually are required to pay the purchase price in full with a cashiers' check as soon as the bidding is over. Bidders will have conducted research to make certain they are bidding on a first trust deed and not a second. They often have not entered the property to ascertain its condition. Because some owners have been known to vandalize their homes before they are forced to relinquish them through foreclosure proceedings, foreclosure-sale buyers account for this risk and generally bid quite low. Sales of this type would almost never be used to determine market value.

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On the other end of the spectrum are short sales which have become more common in recent years. Short sales are not strictly speaking foreclosure sales, but they do involve some duress. With short sales, the owner is typically behind on the payments and often owes more on the home than it is worth. This condition is 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 a real estate agent, with the condition that the lender can approve the sale price. Depending on the terms of the agreement, the owner may be relieved of the obligation to pay for the loss if the property cannot be sold for the full amount of the outstanding mortgage. Or, the agreement may leave the owner open to a deficiency judgment, which would require payment of the difference between the sale price and the mortgage amount if the lender elects to sue to try to collect in court.

Lenders prefer short sales because they save the time and expense of a foreclosure, and homeowners are often cooperative and do not damage the property since they have a vested interest in the sale price. Short sales are listed in the local multiple listing service (MLS) just like any other property, so unlike foreclosures, they are not limited to a certain type of buyer. Unquestionably, there is an element of duress involved in a short sale, but if there are numerous short-sale properties available in an area, there is a good chance that potential buyers will opt to purchase them over conventional listings to save money. Eventually, homeowners selling for the typical reasons will have to lower prices to compete. In this way, short sales may become the predictor of where the market is going. In any event, if a majority of sales in an area are short sales, their influence on the market can hardly be ignored.

Another type of duress-driven sale is known as the "deed in lieu of foreclosure." These sales occur when owners relinquish the deed to the lender rather than forcing it to obtain the property through the foreclosure process. The lender then markets the property usually through the MLS. Often builders will use this method to alleviate themselves of mortgages, which explains why there may be clusters of newly constructed homes in a certain subdivision offered for sale by a lender. These sales, called REO for "real estate owned," have the same effect on the market as short sales. Another tactic builders use to reduce their excess inventory is to heavily discount the homes or even sell them at a loss. This pricing strategy may, in some instances, enable buyers to purchase new homes for prices lower, or only slightly higher, than similar used homes. Since builder-discounted homes, short sales, and REO properties are listed among the other properties for sale in the MLS, assessors may find it difficult to identify them for exclusion without further examination of each listing.

### Time is of the Essence

Under these market conditions, it is important for assessors to consider the timeliness of the sales when making choices about which sales to include the determination of value. Even if short sales are not considered in a valuation study, assessors can get closer to the current market value of properties by using the most recent sales and excluding older ones that they might ordinarily have used under normal circumstances. For instance, in a normal market, sales may be examined as far back as six months to a year, but in a declining market, sales older than two or three months may already be obsolete. In addition, more weight can be given to the newest sales—even within a three-month period. For example, in a three-month sales study, properties that have sold in the most recent month may receive three times the weight of properties that have sold in the oldest month. Similarly, properties that sold in the middle month may be given double weight.

Therefore, by selecting the most recent sales, the assessor may be able to account for the market impact of short sales without actually including them in the data—assuming, that is, that short sales have not saturated the market to the extent that there are no normal sales available. It also should be remembered that a sale that closed in a given month was probably in escrow for at least 30 days before that, meaning it probably defines the condition of the market one month prior to the closing date. And in today's fast-changing market, one month can make a difference.

## Check the Listings

A recent trend in fee appraisal assignments has lenders asking not only for sales that have closed within the last three months, but also for current listings of similar properties. With the market changing so rapidly, such a request is not unreasonable. On a recent assignment, a fee appraiser, looking at sales over the previous three months, set the value of a property at $380,000. However, when he checked the current listings, he found several homes in the same subdivision with the same plan with asking prices of around $360,000. He had to revise his initial estimate to take this new information into consideration, and make time adjustments to the sales to reflect the percentage of decline.

Listings, it should be noted, only determine the upper limit of a property's value. They often are not good indicators of true market value because sellers may not have adjusted their expectations to the realities of the market and may still be asking excessive prices.

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When listing prices are used, a "listing to sale price adjustment" should be considered. This adjustment is based on the ratio of the listed price to the sale price that is prevalent in the market. In other words, if properties typically end up selling for about 95 percent of the asking price shown on the MLS, this percentage can be used to calculate the potential sale price of listings—provided the properties have been reasonably priced. In many assessment offices, examining MLS listings has not been part of the normal revaluation procedure, but in this new market, it could be an important tool. If lenders are requiring listing information of fee appraisers to determine how much they will lend, then assessors may want to include this data as part of their revaluation research.

## Concessions Skew Sale Prices

Sales concessions have become very common, and typically inflate sale price by about 2 to 3.5 percent. Without calling the listing and selling agents on each sale, it is difficult to ascertain whether a sale has included concessions. Some assessors send questionnaires to new owners, which can provide a way to estimate the percentage of sales that involved concessions. However, even if it could be determined that, for instance, 60 percent of all sales included concessions, it would be difficult to apply the proper adjustment without knowing which sales were affected. Nevertheless, if it is known that concessions are prevalent in the market, and an appraiser has a range of values from which to choose, he or she may want to take this factor into consideration.

## Realities of the New Market

Economists are fond of saying that the economy goes through cycles. However, the present financial situation, at least in the United States, is unprecedented. It is not that the U.S. has never experienced a marked decrease in the real estate market before; rather it is that the financial condition of the country (and homeowners) has never been as it is today in the midst of such a real estate decline. To gain a better perspective on the current situation, some historical knowledge is valuable. A century ago most home purchases required a down payment of at least 20 to 25 percent. And decades ago, with the exception of Veterans Administration (VA) and Federal Housing Administration (FHA) financing, most home loans required at least 10 percent down. In January 2006, a survey conducted by the National Association of Realtors showed that, of the new owners who responded, more than 40 percent had purchased their homes with no money down (Tse 2006, F1)., If concessions had been included in those sales, the buyers would essentially have been paid to buy their homes. Consequently, except for the negative impact on their credit rating, these buyers may see no financial reason to keep making payments on homes that are now worth less than their mortgage. In addition, many homeowners were tempted by easy access to home equity loans to spend their equity to maintain a lifestyle that was above their means. Many of them are now finding that the equity "piggy bank" is empty, but the increased mortgage payments must still be paid.

Furthermore, the Federal Reserve Bank's monetary policy aimed at alleviating the mortgage crisis does not seem to be working as expected. One of the reasons that the U.S. is in this debacle is that interest rates have been held down for so long. So what is the solution at the Fed? Lower them some more—or at least lower them towards where they were around 2003, when rates were the lowest they had been in 40 years. The problem with this strategy is that because the previous buyers of mortgage-backed securities have lost so much money on bad loans, and because all mortgages are looking riskier, there are fewer investors willing to buy. And with fewer buyers for mortgage-backed securities, the reduction in rates is not having the intended effect. Mortgage rates are not coming down substantially, even as the Fed lowers the discount rate.

These factors not only mean that the current storm may not soon be quelled, they also put the U.S. in a "Catch 22" position that is unprecedented. The country's debt binge has been made possible because the dollar has been the world's reserve currency and it is also the currency in which oil is traded. But as the dollar loses its value, oil costs are increasing, and the Euro has begun to look more attractive to international investors. This is pushing the U.S. to make some difficult choices. Will the Fed continue to keep interest rates low and risk a steep increase in inflation? Because if rates are kept low, more money must be printed, which will increase costs for everyone. Or will the rates be raised, which will have the effect of increasing housing mortgage costs in an already troubled real estate market—possible reducing values even further and postponing any hoped for recovery?

The choices are not pleasant, and markets generally do not stabilize when economic conditions are in turmoil. The realities of these circumstances portend that the valuation of properties, especially with the use of mass appraisal techniques, will only continue to be more challenging. To keep values accurate, assessors may be faced with the necessity of increasing the monitoring of markets, delineating more segregation and diversification of neighborhoods, and putting a new emphasis on the timing of sales, among other requirements. And this additional workload is coming at a time when resources may be shrinking—meaning assessors will be faced with doing more with less. ■

## Reference

Tse, T.M. 2006. Down payments' downward trend. *Washington Post.* January 21.

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## Types of Nonmarket Sales with "Undue Stimulus"

### Short Sale

Buyer cooperates with lender to sell property. Property most like is listed in local MLS, and is marketed along with normal sales, making it available to any buyer. The lsiting will generally have a comment stating that it is a short sale and subject to bank approval. In some areas, the MLS will require special paperwork for writing the purchase money agreement.

### Foreclosure Sale or Sheriff's Sale

The bidders are at risk because they generally cannot go inside the property and it may have deficiencies that are expensive to repair. Sometimes buyers who are being evicted tear out plumbing or HVAC systems or vandalize property in other ways before they leave. Bidders also risk buying second or third mortgages, instead of a first, so research is required to avoid such a mistake. Bidders must have all the cash in the form of a cashiers check to pay at the auction, which generally takes place on the courthouse steps. Generally these sales should not be used to determine market value.

### REO Sale

Stands for "real estate owned" and is a lender sale. The lender has already taken possession of the property and is now the owner. The property is most likely listed in the local MLS, and it is marketed along with normal sales, making it available to any buyer. It is rare, but some REOs may be auctioned off, or sold directly from the lender; perhaps advertised on lender's Web site. Lender might have acquired property by "deed in lieu of foreclosure" in which the buyer voluntarily deeds the property back to the lender. Property is generally not damaged by the buyer.

### Fannie Mae Sale

Generally, Fannie Mae property is marketed in the MLS along with normal sales. There is a 10-day period during which a buyer can to back out of a Fannie Mae sale. Often, property is in substandard condition.

### VA Sale

When the U.S. Department of Veteran's Affairs, previously know as the Veteran's Administration, repossesses property, it is generally listed in the local MLS, and is marketed along with normal sales, making it available to any buyer. Often property is in substandard condition.

### FHA Sale

Generally marketed along with other properties in the MLS. Often property is in sub-standard condition.

### Other Auctions

These are becoming more common as the market declines. However, some have no reserves, others start at a certain price minimum, and property may actually sell at a price similar to the a typical market sale. Generally these sales should not be used to determine market value.