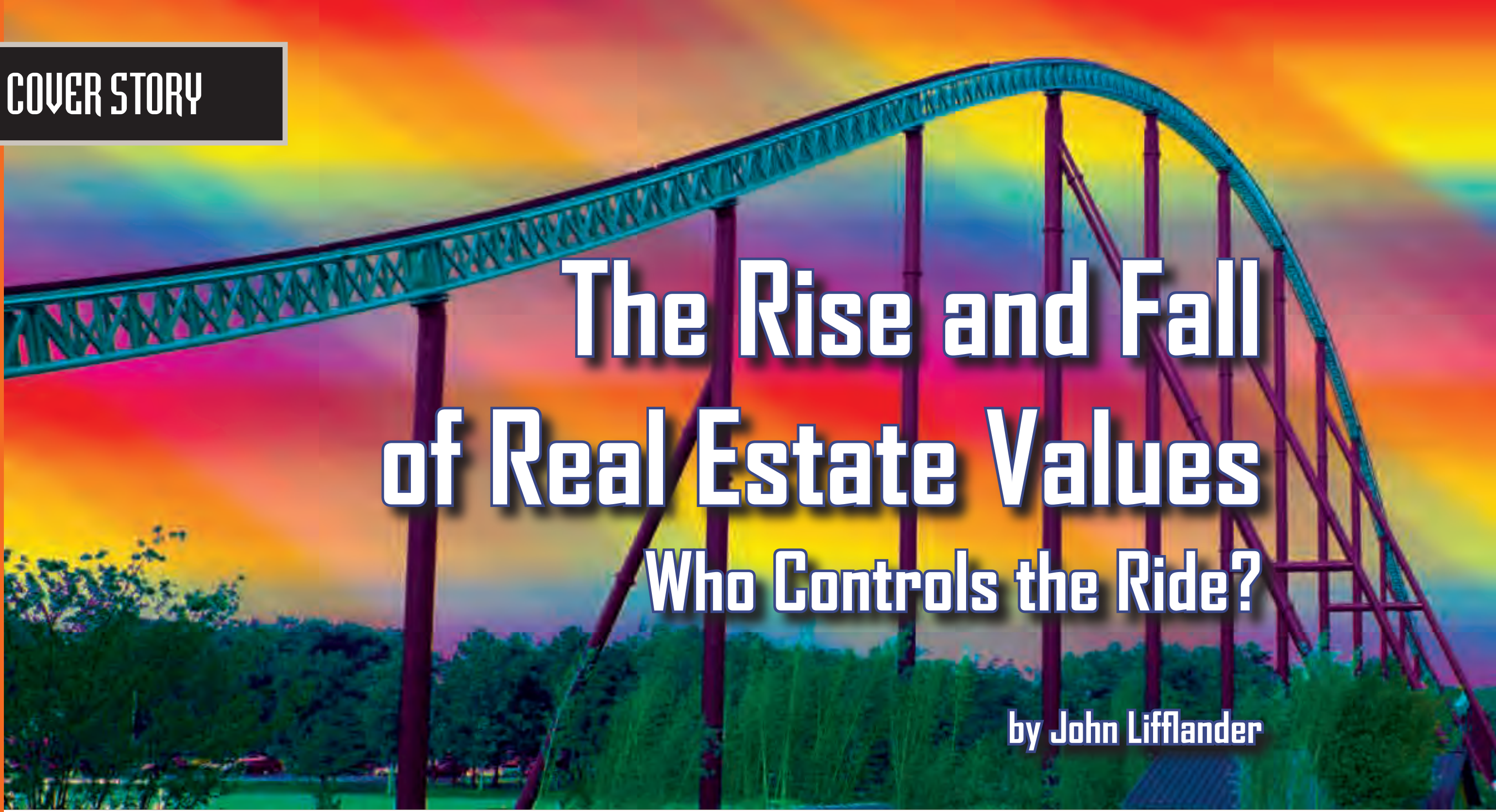
COVER STORY



The Rise and Fall of Real Estate Values

Who Controls the Ride?

by John Lifflander

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Assessors are facing the challenge of assessing property in a roller-coaster of a real estate market. In the past several years values have increased quickly, but now they are descending in most areas, making valuations more difficult and increasing assessors' workloads. To understand how to deal with this problem, it is helpful to understand how it occurred.

How This Started—The Federal Reserve's Part

In September 2007, Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve System (the Fed), explained on *The NewsHour with Jim Lehrer* (September 18, 2007) that "we've had a bubble in housing." He also spoke on the television show *60 Minutes* with Lesley Stahl (September 13, 2007) in the wake of the subprime mortgage and credit crisis in 2007, saying "I really didn't get it until very late in 2005 and 2006." It is interesting that Greenspan did not "get it" because he essentially started it. He lowered rates and kept them down during President Clinton's administration and continued to do so during the second President Bush's administration; that practice has been a major reason for the current problems in the real estate market.

Greenspan was able to get away with the rate reductions because government indicators showed that inflation was under control. However, those indicators are skewed because the government measures only core inflation, which does not count food and energy cost increases, causing economists to say that "Core inflation makes sense only for people who don't eat or drive" (Cooper 2007). It also ignores selected items for other reasons; for example, the increase in the cost of cars is not counted because it is claimed that cars are always improving.

> ***However, the real problem was, and continues to be, the fact that lenders can hire their own appraisers, and this practice immediately puts the appraiser in the position of having to please the lender to stay in business. This is akin to the proverbial fox guarding the henhouse, but it has been ignored by the banking establishment.***

Nevertheless, beginning in the 1990s there was a reason many manufactured items did not increase in cost: the influx of goods made in China. With the cheapest labor costs in the world, China began exporting items at prices well below those for anything manufactured in the United States. This forced many companies to either go out of business or make their products overseas. As a result, prices for many items went down, even if the cost of other items increased. The average, however, made it appear that inflation was relatively low.

All these factors gave the government an excuse to keep rates down for a prolonged period of time, and eventually housing prices started to escalate. Typically, when Americans want to buy a house, they look at the monthly payment that fits their income, not the price of the property. So if rates are lowered, prices are bound to eventually increase. For instance, if a person is borrowing $400,000, the payment with a fixed mortgage amortized over 30 years is approximately $2,938 per month at 8 percent, as compared with $2,398 per month at 6 percent. The difference is $537.00 per month, which allows a lot more people to qualify for such a loan. Figure 1 and table 1, based on data from the Fed, tell the story of how rates were changed. Figure 1 shows the rates since 1990. In 1994 and also during 1997 and 1998, rates were historically low, but they decreased to their lowest in more than 40 years in 2002–2004.

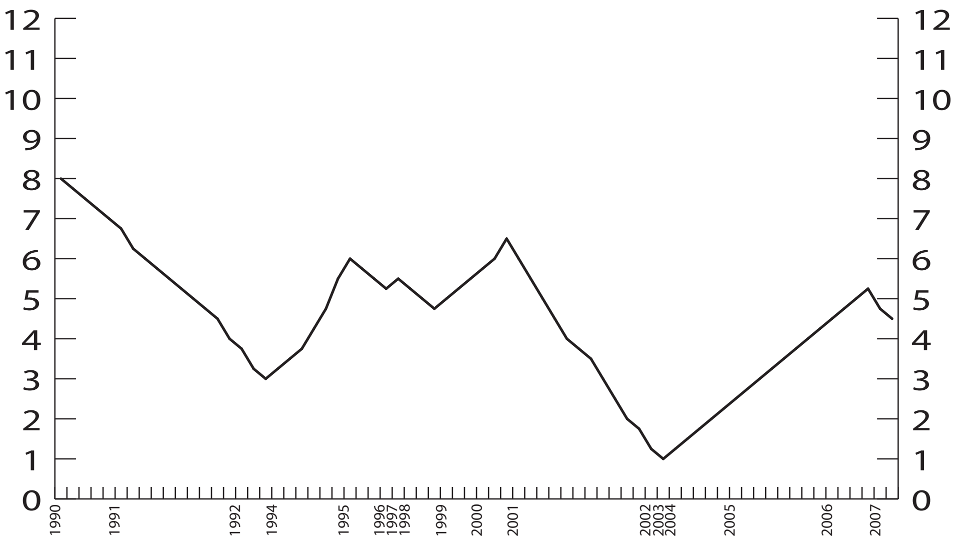
Table 1 shows the differences and the increases and decreases since 1990. Note how the rate in 1990 (8 percent) decreased steadily from that time forward.

Figure 2 is an overview for the 52-year period from 1954 to 2006. Note that the rates are lower in recent years than in the preceding 40 years.

Certainly the argument could be made, as many have, that the Fed was acting irresponsibly. In the October 1, 2007 issue of *BusinessWeek*, Vitaliy Katsenelson, an author and portfolio manager, speaking of the latest rate cut by the Fed said, "The 2001 rate cuts caused the bubble that is now a crisis. Indeed, at the core of today's credit mess—whether in housing or the now battered markets for commercial paper—lies a glut of global liquidity. That has dramatically altered our perception of risk and fueled an unwillingness to accept traditional credit limits."

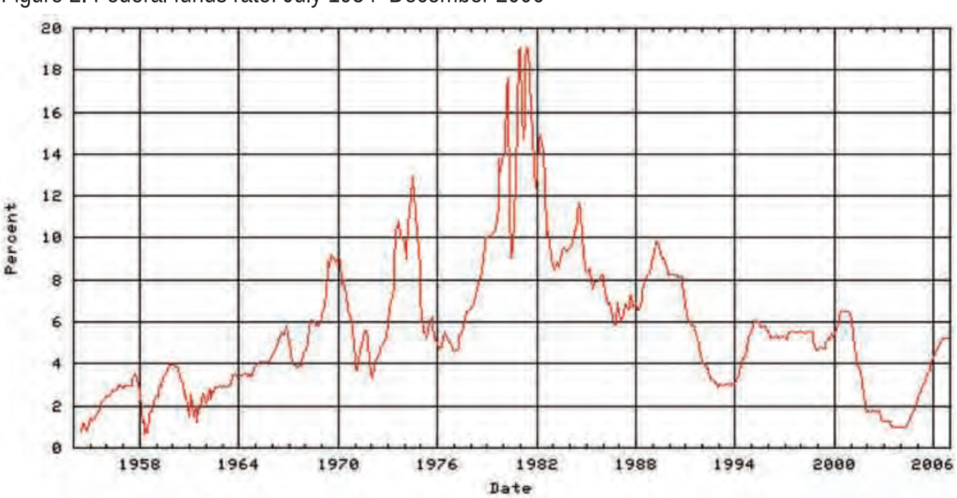
This leads to the second factor causing these problems. Besides the fact that money became "cheap" when the Fed lowered rates, it also became more available because lending practices loosened. Irresponsible changes occurred, such as the Fed's reserve requirements for banks, which were loosened in the late 1980s, allowing banks to keep a lower percentage of deposits and therefore lend a higher percentage of their funds.

Figure 1. Federal funds target rate: 1990–2007



Source: Adapted from Federal Reserve, http://www.federalreserve.gov/fomc/fundsrate.htm (accessed December 3, 2007)

Figure 2. Federal funds rate: July 1954–December 2006



Source: http://www.answers.com/topic/federal-funds-rate?cat=biz-fin (accessed December 11, 2007)

The Mortgage Lenders' Part

As rates declined, mortgage lenders also loosened their requirements and invented new types of loans based on the fallacious supposition that people would be able to pay more in the future, since real estate and wages would continue to increase indefinitely. Many of these loans were given to people with good credit who wanted to buy more expensive homes than they could otherwise afford. With an adjustable rate mortgage starting at 3 percent, for example, the monthly payment on a $400,000 mortgage is only $1,686 per month, $712.00 less than the $2,398 required at a 6 percent rate. As Mr. Katsenelson goes on to say in the *BusinessWeek* article, "If a home owner couldn't qualify for a conventional mortgage, brokers were more than happy to offer an exotic loan the borrower could never realistically pay off. If a loan was too risky to be sold as investment-grade, investment banks could always concoct elaborate bundles of good and toxic credits that (supposedly) eliminated risk."

At the same time, the advent of subprime lending was perhaps the most serious development to lead to the present quagmire. The biggest player in that market was a company called

Table 1. Intended federal funds rate: change and level, 1990 to present

Date	Change (basis points*)		Level (%)
	Increase	Decrease	
2007			
September 18	...	50	4.75
2006			
June 29	25		5.25
May 10	25		5.00
March 28	25		4.75
January 31	25		4.50
2005			
December 13	25		4.25
November 1	25		4.00
September 20	25		3.75
August 9	25		3.50
June 30	25		3.25
May 3	25		3.00
March 22	25		2.75
February 2	25		2.50
2004			
December 14	25		2.25
November 10	25		2.00
September 21	25		1.75
August 10	25		1.50
June 30	25		1.25
2003			
June 25		25	1.00
2002			
November 6		50	1.25
2001			
December 11		25	1.75
November 6		50	2.00
October 2		50	2.50
September 17		50	3.00
August 21		25	3.50
June 27		25	3.75
May 15		50	4.00
April 18		50	4.50
March 20		50	5.00
January 31		50	5.50
January 3		50	6.00
2000			
May 16	50		6.50
March 21	25		6.00
February 2	25		5.75
1998			
November 17		25	4.75
October 15		25	5.00
September 29		25	5.25
1997			
March 25	25		5.50
1996			
January 31		25	5.25
1995			
December 19			5.50
July 6		25	5.75
February 1	50	25	6.00
1994			
November 15	75		5.50
August 16	50		4.75
May 17	50		4.25
April 18	25		3.75
March 22	25		3.50
February 4	25		3.25
1992			
September 4		25	3.00
July 2		50	3.25
April 9		25	3.75
1991			
December 20		50	4.00
December 6		25	4.50
November 6		25	4.75
October 31		25	5.00
September 13		25	5.25
August 6		25	5.50
April 30		25	5.75
March 8		25	6.00
February 1		50	6.25
January 9		25	6.75
1990			
December 18		25	7.00
December 7		25	7.25
November 13		25	7.50
October 29		25	7.75
July 13		25	8.00

**A basis point is 1/100 percentage point.*

Source: Federal Reserve, http://www.federalreserve.gov/fomc/fundsrate.htm (accessed December 3, 2007)

Ameriquest, which targeted people with bad credit and made loans to them for exorbitant rates. In 2006, Ameriquest paid a record $325 million to settle a class-action lawsuit over allegations of predatory lending practices, such as bait and switch and usury.

However, while Ameriquest was in its heyday, making millions of dollars with subprime loans, other lenders noticed and joined in. New companies were created only for this business and many of them are now defunct. General Electric got into the business with WMC Mortgage, and "A" paper lenders such as Countrywide, the largest mortgage lender in the United States, joined in with its Full Spectrum branch. Moreover, lenders like Washington Mutual, although they did not make subprime loans, were buying packages of subprime loans from lenders like Ameriquest. If the Fed had been irresponsible, the lenders compounded it by their shortsighted practices. They also forgot a basic rule in lending: people with bad credit who do not pay their bills generally do not change. And adding to this mess is the fact that the loan broker rarely has a stake in what happens to the loan after it is made, since it is generally sold off to another entity.

The Appraisers' Part

After the real estate meltdown in the 1980s, the government decided that appraisers should be licensed. Licensing was supposed to protect the public from fraudulent loans, because appraisers would be sufficiently educated in the profession. That would have been a grand solution if education was really the issue before licensing was required. However, the real problem was, and continues to be, the fact that lenders can hire their own appraisers. This practice immediately puts the appraiser in the position of having to please the lender to stay in business. This is akin to the proverbial fox guarding the henhouse, but it has been ignored by the banking establishment. In fact, in the 1980s HUD/FHA (U.S. Department of Housing and Urban Development/Federal Housing Administration) appraisers were assigned to cases just as VA (U.S. Department of Veterans Affairs) apprais-

Figure 3. Appraisers' petition

Concerned Real Estate Appraisers from across America

Submit the attached petition (Which was posted on appraisersforum.com):

To: Mr. Ben Henson - Executive Director
Appraisal Subcommittee (ASC)
Federal Financial Institutions Examination Council
email: benh1@asc.gov

cc: Other state or federal agencies with authority in the following matter

"The ASC's mission is to ensure that real estate appraisers, who perform appraisals in real estate transactions that could expose the United States government to financial loss, are sufficiently trained and tested to assure competency and independent judgment according to uniform high professional standards and ethics." From the ASC website.

The concern of this petition has to do with our "independent judgment" in performing real estate appraisals. We, the undersigned, represent a large number of licensed and certified real estate appraisers in the United States, who seek your assistance in solving a problem facing us on a daily basis. Lenders (meaning any and all of the following: banks, savings and loans, mortgage brokers, credit unions and loan officers in general; not to mention real estate agents) have individuals within their ranks, who, as a normal course of business, apply pressure on appraisers to hit or exceed a predetermined value.

This pressure comes in many forms and includes the following:

- the withholding of business if we refuse to inflate values,
- the withholding of business if we refuse to guarantee a predetermined value,
- the withholding of business if we refuse to ignore deficiencies in the property,
- refusing to pay for an appraisal that does not give them what they want,
- black listing honest appraisers in order to use "rubber stamp" appraisers, etc.

We request that action be taken to hold the lenders responsible for this type of violation and provide for a penalty on any person or business who engages in the practice of pressuring appraisers to do dishonest appraisals that do not provide for independent judgment. We believe that this practice has adverse effects on our local and national economies and that the potential for great financial loss exists. We also believe that many individuals have been adversely affected by the purchase of homes which have been over-valued.

We thank you for your cooperation and assistance.

ers are today. It was a random assignment system that precluded any involvement of the appraiser with the lender to procure the work. However, that practice stopped after the banking industry lobbied Congress to allow lenders to choose their own appraisers for FHA loans.

The pressure that appraisers face is tremendous, and it has resulted in a petition (figure 3) from "Concerned Real Estate Appraisers from across America" to the Executive Director of the Appraisal Subcommittee of the Federal Financial Institutions Examination Council.

Unfortunately, many appraisers give in to inflating values to retain their livelihood, which has added to the problems of the current real estate debacle. Appraisers find that even long-time clients do not call them back if they fail to "bring in the value" for even one transaction. Moreover, the appraiser is often labeled as a "bad" appraiser if the value is not as requested. This travesty has resulted in honest appraisers being punished by not getting work, and dishonest appraisers being rewarded with more work, even though they perform fraudulent appraisals.

Other Contributing Factors

Including owner concessions in the purchase money agreement is another factor that has inflated values. Once a rarity, it has become a common practice—probably because of the malleability of appraisers—for everyone to assume that the value will come in regardless of the padding of "thin air" to the sale price. For example, a buyer wants to make an offer that is $7,000 lower than the property's listed price of $280,000. Instead of offering $273,000, the buyer offers the full price with concessions of $7,000. The concessions might be attributable to closing costs or to a rebate, but the effect is that the lender is financing a larger percentage of the market value of the property.

Concessions have a twofold effect on the market. First, as they have become common, they inflate values approximately 2 to 3 percent, depending on the amount. Second, when appraisers or buyers and sellers look at sales, many of the sale prices do not reflect the actual money paid for the house. Moreover, appraisers rarely know if there are concessions associated with the sale comparables they are using, because they are not noted in most multiple listing services, and calling each party to the loan is too time consuming, and often agents are unwilling to cooperate.

Essentially what has occurred, at least in many parts of the United States, is an increase in values not driven by solid real estate economics, but by unrealistic speculation, loose lending practices, fraudulent appraisals, and cheap money. These factors fueled an inflated bubble in prices, and assessors around the country found it difficult to keep up with the drastic increases in real estate values.

Another reason for the decline in the current market situation in most areas is the fact that the majority of real estate investors have left the marketplace and instead are attempting to sell their properties. Many of those who invested in real estate in the past several years were previously in the stock market or had never invested before but wanted to "get in the game" because they saw large increases. Some first-time investors used equity lines on their homes to make the down payments for their purchases. These "amateurs" often paid more for homes than savvy real estate investors normally do, driving prices sky-high. It is estimated that the amount of real estate purchases for single-family residences bought by investors is between 10 and 25 percent, depending on the region of the country. With these people no longer buying and with some selling, inventory is increasing and prices are decreasing.

In the multifamily residence market, capitalization rates have descended over the past several years; this drop is related to lower interest rates and optimistic overspeculation. The lower the capitalization rate, the higher the value. And in many areas of the country capitalization rates decreased substantially as interest on FDIC-insured certificates of deposit (CDs) decreased because of the decrease in the Fed's prime rate, which also decreased mortgage costs.

Investors who had previously kept their funds in CDs and other interest-bearing financial instruments became disenchanted as the rates subsided. The alternative of real estate investments became more palatable—although the capitalization rates may have sunk to 5–6 percent, they were still higher or as high as CD rates and real estate values were increasing quickly. Income-producing property was also increasing in value faster than many stocks, so many stock market speculators switched to real estate as well.

The Resulting Ad Valorem Problems

Essentially what has occurred, at least in many parts of the United States, is an increase in values not driven by solid real estate economics, but by unrealistic speculation, loose lending practices, fraudulent appraisals, and cheap money. These factors fueled an inflated bubble in prices, and assessors around the country have found it difficult to keep up with the drastic increases in real estate values. Those jurisdictions that are under a mandate to revalue annually have been particularly affected. The job of keeping up is further complicated by the fact that the application of increases often lags the market by at least a year. In other words, market values may have increased for the time period under assessment and then decreased afterwards, making the increased property tax bill appear inaccurate because the current market had decreased in the meantime.

One solution for the future would be to develop an awareness that drastic increases may constitute a market swing, and it may not be worth increasing assessments until the market stabilizes. The problem with implementing this policy could be the legal mandate for many assessors that that they value property as of a certain assessment date. In any event, one way of ameliorating the backlash for increased assessments that now appear untimely is for assessors to make a special effort to educate property owners. Assessment offices need to be very clear about the date for which the assessment has been made and also to explain that reductions, if warranted, will occur the following year and go down as quickly as they increased. ■

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