“Closing the gap between sales price and appraised value”

Lately, there have been more than a few “would be sales” that didn’t close because of “low values”. Many are blaming the Home Valuation Code of Conduct (HVCC) and its “unintended consequences” for the gap between contract price and appraised value.

The HVCC added a few twists to the appraisal process, mandating separation of those ordering appraisals (lenders, mortgage brokers, etc.) from those completing them. It has been a catalyst for increased reliance on AMCs (Appraisal Management Companies) and disconnection of traditional lines of communication.

Often, the appraisal process leaves unanswered questions about low valuations. As a result, many are calling the HVCC a “deal killer”. Various housing related groups including Realtors®, home builders, mortgage brokers and appraisers have called for its modification or repeal.

At question, is the HVCC the culprit or is something else causing or contributing to the value problems? There’s no doubt that the HVCC signaled a shift from business as usual. However, did it cause a sudden rash of “low-balls” or are other factors at work?

Failure to communicate

From the real estate agent’s perspective, “if I have a buyer that’s willing to pay $200,000 for a property and a seller that’s willing to sell it for $200,000, that meets the test of willing buyer and willing seller and therefore market value”.

Seems reasonable, but then again, the secondary market’s or lender’s definition of market value is far more complex. Their definition requires “statistical probability”, in essence “the value to the many, not value to the one”. From the lender’s perspective, “if 100 potential buyers were considering the subject property, what is “the most probable price” the majority would pay?”

Answering that question is no easy task in a normal market, let alone one that is impacted by foreclosures, REOs and short-sales. Today, you have a “good guess at best”. More often than not, it’s the misunderstanding of the lender’s market value definition that is responsible for the “value gap”.

While the definition recognizes “willing buyer and willing seller”, there are many “market value refinements” that must be factored into the appraiser’s opinion. For example, the price of the comparables can’t be affected by “undue stimulus”. Essentially, an isolated high sale (due to seller contributions) or low sale (that was prompted by duress) wouldn’t represent market value.

On the other hand, in areas dominated by REOs and short-sales, those homes can become the comparable sales and listings the appraiser is required to consider. Why, if they are similar in most respects to the subject property (physically, condition, etc.), they represent “substitute alternatives" an informed buyer would or should have considered. Even if only for a short-term, those sales affect the market value opinion at that point in time.

Another issue that impacts many transactions is the requirement that comparable sales must be adjusted for "financing concessions". For example, an agent lists a property at market for $300,000. After a reasonable time, the seller receives a "full price offer" with the buyer asking for three points towards costs. The seller counters, agreeing to the points but increasing the price to $309,000 to cover the cost. The sale closes and records.

In this case the three points "affected the price" when the seller opted to add the points to the price. When appraisers verify the sale, they'll likely make a negative adjustment (up to the three points) to the recorded sale price. Sometimes, the concession will not be disclosed in the MLS. Another agent listing a similar property may use this sale in their CMA, unaware of the concession and or not adjusting for it.

The new property gets listed for $309,000 and from the start, there could be a $9,000 difference between the new listing and the appraiser's adjusted comparable. When the value comes in short, the seller and agent don't understand. Why, because they don't understand the secondary market's definition of market value and how it is applied to sales data.

It's no secret that prices have been declining in our market. A common issue over the past several years has been time adjustments. Appraisers are required to make adjustments for declining prices to the comparables based on the contract date, not the closing date.

If the market had been declining at 2% per month, a comparable that closed one month ago (but entered contract 3 months ago), would be adjusted negatively for changing market conditions or time. In this case the sale price would be adjusted downward for 3 months or 6%.

An agent developing a competitive market analysis for a client would need to make a similar adjustment to the comparable sales used in their CMA to remain consistent with the market and the appraiser.

Getting on the same page as the appraiser

What are the appraiser's motivations to come in low? They haven't any. In 35 years, I have never had a lender call me up, ask me what my fee is for an appraisal, and then ask me how much I would charge to bring it in low.

Lenders don't want low values because they want to make the deal. Appraisers don't want to come in low because they don't want the complaints and they don't want to deal with the problems. If anything, appraisers do extra work to make sure they didn't miss any data that would support the contract price. Being embarrassed by missed sales doesn't sit well with clients and doesn't score referral points with agents or lenders.

At the same time, appraisers have the obligation to follow the lender's appraisal guidelines and supplemental appraisal guidelines from the secondary market, making the required adjustments, even when there are multiple offers or someone willing to pay a higher price.

Market value is not about what someone is willing to pay. It's about what someone should pay, "if they knew the market (and looked at all the available homes), were in a position to buy, but didn't have to buy, were motivated, but not under the gun and not enticed by a financial gift from the seller or anyone involved with the deal".

The definition of market value is based somewhat on theory and somewhat on fact. Much of the criteria doesn't exist in pure form or isn't abundantly clear to market participants. Still, the appraiser is required to adjust comparable sales as if those conditions and criteria exist and are apparent to all participants in the market.

Improving the process?

If the agents' Competitive Market Analysis is based on sales that do not meet the "lender's market value criteria", there will likely be a difference between the CMA and the subsequent appraisal, it's that simple.

There are several steps we all can take to "close that gap".

1. Verify the comparables sales you are using for your CMA with the selling agent and make the adjustments. It's easier to explain this to the seller prior to taking the listing than it is to deal with the seller after the value comes in short of the contract price.

2. Make sure you adjust for market conditions or time. If neighborhood prices have been going down 1% per month, adjust your comps from the contract date, not the closing date.

3. After the property is sold, update the listing (even before it closes) so that other agents and appraisers know what transpired, including concessions and needed repair work.

4. Don't just tell us what sold and when; tell us why it sold for that price. Most buyers get a home inspection and that will give all a good insight as to the condition of the property.

5. When the appraiser calls, take the call or return it. While some information cannot be disclosed by the agent, work with the appraiser as much as you can so that they have the best possible data. When possible, get permission from the seller and or buyer to release the contract price (prior to closing) to licensed appraisers.

Incorporating a specific informational area or set of fields within the MLS to assist the appraiser (and other agents) with respect to the listings and comparables to disclose key information would go a long way to eliminating calls and e-mails, while at the same time providing all that rely on the MLS, with much needed information and observations.

Vague listings with limited data, comments or photos contribute to valuation problems. For example, most listings don't state the property's condition until post closing. Often, the agent's opinion of condition can vary substantially between agent to agent, since "condition" isn't defined (and it should be).

Pending and contingent listings are a key to knowing which way the market is moving, yet agents cannot disclose the contract price. Even so, simply having a field (or comments) that would indicate the property is in contract above/below/at list price would be helpful when trying to support market movement, shifting conditions and the need for (or no need for) time adjustments.

We all drink from the same well, the MLS. Agents control that well. Appraisers rely on the listing information and the agents to verify details, concessions and motivations. Improving the quality of the data and verifying the details will improve the appraisal process.

Even though verifying a sale may take some of your time, for a deal you have nothing to do with, it is likely that the appraiser is working on an appraisal that involves another agent. The outcome affects the other agent and in turn, the market.

We're all part of the real estate transaction and we all have a vested interest in a healthy housing market. There are some things we can't fix and some things we can. The more we understand the appraisal process, the better we can work together to resolve the issues.

If we don't have confirmed sales and pending data to support a higher price or stable market trends and we have current listings of similar properties at lower prices (many listings are under-priced), we don't have the information we need to support different findings in the appraisal. Therein is the problem.

About the author:

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