News and analysis for the real estate appraisal industry

# Valuation Review

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**FEATUREREPORT**

# Concessions shadow appraisal industry

*Appraisers facing potential land mines in sales contracts*

A growing hurdle on the road to ensuring accurate property valuations is the increasing trend toward sales concessions to attract buyers on the fence.

Homebuilders and sellers are throwing in everything — from routine closing costs to luxury automobiles, boats and exotic vacations — to get the deal done.

A seller may include a $50,000 BMW with the sale of a $500,000 home. The actual value of the real estate is $450,000, but that isn't always what is being shown as the deal enters the land of comparable sales.

Appraisals often ratify sale prices, whether justified or not. Often, it is a result of the pressure applied to appraisers to meet the higher values. It also can contribute to an increase in foreclosures, a growing problem in several parts of the country.

> "We're going to take very seriously brokers who fail to list sales concessions."
>
> *— Erin Toll, director, Colorado Division of Real Estate*

■ See **CONCESSIONS** on Page 5

## UPFRONT



## ONDECK

■ The cost approach seems like it should be second nature for real estate appraisers. Instead, this valuation method can be a thorn for new appraisers and veterans alike. *Valuation Review* will talk to some experts about the challenges of this method of appraisal.

■ Appraising foreclosed properties can be a profitable business move, but you'd better be prepard. *Valuation Review* will give you the ins and outs.

*Breaking News*

# ValuationLogic adds Risk Score to evaluations

ValuationLogic announces expanded functionality of its CollateralLogic automated residential appraisal report evaluation product to include a Risk Score to provide a better understanding of the risks associated with the property and the appraisal that was performed.

"This new functionality looks at the individual risk levels assigned by the lender and provides an appraisal and property score," said **Robert Palmer**, ValuationLogic's founder.

"Based on the lender preferences, any one risk item has the potential to red flag the collateral for loan consideration independent from other, positive factors. Therefore, the higher the score, the higher the risk," he said.

CollateralLogic automates the process of risk/issue identification, allowing a lender's resources to be focused on issue resolution. The addition of a risk score assists lenders in accelerating the collateral review process by directing higher risk appraisals/collateral to the right level of expertise for resolution.

CollateralLogic evaluation guideline and scoring engines are customizable to match the lender's collateral guidelines.

CollateralLogic helps lenders address fraud and risk concerns that could result from inflated values created when pressure to meet production goals conflicts with sound appraisal processes at the point-of-sale.

With the risk score, the appraisal evaluation takes less than 30 seconds. In addition to lender customers, CollateralLogic works for the secondary market where large pools of closed loans must be rapidly reviewed prior to their purchase and subsequent securitization. ■

**ZAIO** — continued from Page 3

exchange rate of $1.17

The transaction is expected to close, subject to receipt of all regulatory approvals including the TSX Venture Exchange, within the next 45 days.

The union could also prove to be profitable, according to **Rodney Mitton**, chief financial officer of Zaio. He said based on year-end 2006 financial performance of each company, they expect combined operations to generate revenues of about $12 million in 2007.

"After closing, three large private equity firms, which had been Realink shareholders, will become shareholders of Zaio," he added. "These firms on an aggregate basis will hold about 6 percent of Zaio's outstanding shares."

The company has completed all of the zones in Spokane, Wash., which served as its pilot city. Several lenders have been purchasing the products, mostly for home equity loans.

"Since Realink has an existing lender customer base placing large volumes of appraisal orders, the acquisition also offers an attractive way of accelerating the introduction of Zaio to lenders, and a method for directing work to our exclusive network of zone appraisers and accelerating their revenues," Inserra pointed out.

Zaio's success may rest on the appraisers it recruits. The company is hosting informational meetings nationwide to spread the word, being greeted by varied responses. Recent meetings in Cleveland and Akron drew a handful of appraisers.

Appraisal industry leaders see the deal as a good move for Zaio, but nothing that is going to change the face of the appraisal industry.

**Jonathan Miller**, CRP, president and CEO of Miller Samuel Inc., a New York appraisal company, told *Valuation Review* Zaio Corp's purchase of Realink makes sense from an expansion strategy standpoint, in that there is a built in base of appraisers that they may be able to tap into.

"However, since they are dependent on spreading the word to appraisers, they appear to be closely tied to the appraisers, good or bad, that buy a zone," he said. "In other words, the quality of the reports generated seems to be decided by which appraiser purchases a zone, not based on competence. Hopefully Zaio will aggressively manage that quality and be able to test the accuracy of each zone. With underwriting standards becoming tighter after the subprime implosion, national models, such as AMCs have been part of the growing problem of appraisal quality."

**Jim Kirchmeyer**, president and CEO of Real Info Inc., a Buffalo, N.Y.-based AVM provider, told *Valuation Review* that while the deal really doesn't mean much for the appraisal industry, it is a good move on Zaio's part.

"It gets them appraisers and lenders they didn't have that Realink has," he said. "It gets them warm bodies."

"I think the Zaio concept is a great idea," he said. "This product stays ahead of the curve and is really a step up from an AVM." ■

## CONCESSIONS — continued from Page 1

In Colorado, **Erin Toll**, director of the state Division of Real Estate recently received an assist in her effort to investigate potential appraisal inflation and loan fraud when Metrolist Inc. agreed to open the doors to its MLS in the Denver area to the agency.

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*— Kathy Coon, chief appraiser and director of appraisal quality control, FNC*

### Granting access

The MLS agreed to let the division access the data after Toll signed a subpoena requesting the information, ending a five-month battle for the information.

Among other things, Toll expects to use MLS records to make sure cash gifts and other concessions to buyers are disclosed because those gifts should be deducted to determine the real sale price.

"We're going to take very seriously brokers who fail to list seller concessions," she said.

The problem is, appraisers certainly know how to avoid using comparable sales that aren't appropriate, but too often they aren't aware of these comps, which are artificially inflated by concessions added into the price.

**Elizabeth Kern**, IFA, president of the National Association of Independent Fee Appraisers, told *Valuation Review* that for a subject property, the inclusion of concessions in an agreement to purchase has no bearing on the appraisal process when the assignment for the property being appraised is for market value.

"Understanding market value and the definition thereof is paramount," she said. "What is happening in many markets, however, is the perception and pressure that the appraisal process should conclude at or near the "contract price," which will include the concessions. Inexperienced appraisers or appraisers that are willing to cave to pressure for quick turn time and to meet a value may arrive at a value that is not truly supportable."

Once the property becomes a recorded sale, the concessions included in the agreement of purchase are generally not recorded, especially when they are cash concessions. Local multiple listing services may or may not include sales concessions/transaction information and in some cases, it will be a "best guess situation" to determine what took place.

"So the question is — what's fair?" Kern said. "If you take the side of Graham-Leach-Bliley, then sales concessions should not be public information. If you take the side of due diligence and complete market understanding, then verifiable concessions should be made public. If society truly wants supportable conclusions then the sales concessions for recorded sales should be available for analysis in some fashion."

### A new trend?

"It is certainly a problem that is growing," **Kathy Coon**, chief appraiser and director of appraisal quality control at FNC, told *Valuation Review*. "Unlike other information, such as the room count, square footage and other facts, seller concessions are so difficult to verify since they are not found in public records or other databases."

**Jacqueline Doty**, collateral policy director, Freddie Mac, told *Valuation Review* that market information indicates there has been a growing prevalence of sales concessions that are being offered by interested parties to property sale transactions since early last year.

"Anecdotally, we've also heard that some appraisers are being pressured to ignore sales concessions and to report a value that may be inflated," she said. "In 2006, we changed our guide to state that when a loan is sold to Freddie Mac, the seller of that loan is contractually obligated to ensure that the appraisers' opinion of value reflects the value of the subject property without the concessions. This clarification reinforces our long-held policy that an inflated value constitutes a contract violation and can trigger a costly mortgage repurchase."

### Taking a position

The U.S. Department of Housing and Urban Development issued a mortgagee letter that clarifies Federal Housing Administration (FHA) policy regarding the responsibilities of mortgagees and appraisers in reporting sales concessions and verification of sales data.

FHA requires mortgagees to provide appraisers with all financing data and sales concessions for properties to be security for an FHA-insured loan. Appraisers are required to identify and report sales concessions and properly address and/or adjust the comparable sale transactions to account for sales concessions in the appraisal of all properties to be security for an FHA-insured loan.

According to the letter, sales concessions influence the price paid for real estate. They may be in the form of loan discount points, loan origination fees, interest rate buy-downs, closing cost assistance, payment of condominium fees, builder incentives, down payment assistance, monetary gifts or personal property given

■See **CONCESSIONS** on Page 6

CONCESSIONS — continued from Page 5

by the seller or any other party involved in the transaction.

HUD, Freddie Mac and others may have guidelines in place, but there are too many transactions that fall outside their realm, thus compounding the issue for appraisers.

One problem, sources told *Valuation Review*, is that appraisers may not be getting the industry support they need to disclose and adjust for concessions properly.

### The equalizer?

In a softening real estate market, seller concessions often become the equalizer.

They can be used to entice buyers who may be on the fence to take the bait and purchase the home.

Coon describes concessions as contributions by the seller to assist the borrower. They can include loan discount points, loan origination fees, buyer's closing costs paid by the seller, interest rate buy-downs, gift down payments or settlement assistance and builder incentives and giveaways, among other things.

"These kinds of items don't add any value to the property, but they are included in the contract price for the sale of the house and that price is supported by the appraisal," she said. "As a result, the concessions indirectly affect market value."

**Jack Blazejack**, MAI, CRE, an appraiser from Miami, Fla., agreed that if a home sells for $300,000 and includes a $10,000 car in the garage the market value is $290,000 for the real estate.

### Define the market

The first thing for appraisers to do, according to Blazejack, is to define the market. The appraiser must decide whether all sales have sellers paying closing costs or if they all have cars in the garage.

"Concessions are marketing tools indicative of a buyer's market," he said. "Sales are soft and sellers have to lower the price or increase concessions. A lender must be careful to only lend on real estate value and not cars, trips to Europe or furniture."

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Concession items, including interest rate buy-downs, closing costs, cars, vespas, trips and common area fees paid in advance all must be adjusted.

"Consider the sale with concessions versus one without to determine market value," he said.

### A simple solution

By doing their due diligence, appraisers can curtail the problem. Even though they may meet resistance from real estate agents and brokers, the valuation professional must be steadfast in their position in securing the information necessary to reach an accurate value conclusion.

"Appraisers should be analyzing the sales contract for the subject property," Coon said. "If there are any substantial concessions, it isn't very likely that the market will support the price being offered."

If the appraiser doesn't make any automatic downward adjustments to the comps for the subject's concessions, it isn't likely the comps will support the contract price that is bloated by the concessions.

### Disclosure requirements

According to Doty, Freddie Mac's guide requires the full disclosure of financing and sales concessions in the sales contract.

She said the policy language is: "The sales price, contract date and loan charges paid by the property seller, or the financing and sales concessions made by the property seller or other interested party to the transaction, must be stated in the sales contract."

The GSE, according to Doty, also has a comprehensive policy guide regarding the handling of sales concessions for both the subject property and comparables.

"The appraiser must report the total dollar amount of any sales and financing concessions, gifts and/or down payment assistance provided by anyone on behalf of the purchasers (purchase transactions) or borrowers (refinance transactions) and must identify which party provided the concessions and/or assistance," she said.

"If the appraiser did not report and analyze any payments made on behalf of the borrower or did not state the actions taken to obtain the information, the lender must contact the appraiser to determine whether an appraisal update is required."

The hitch is that too often the appraised value ends up coming in at or above the contract price.

Coon pointed out that appraisers who think their job ends with analyzing the

■ See CONCESSIONS on Page 7

CONCESSIONS — continued from Page 6

sale of the subject might be short-changing their clients.

"For any comparables that sold with seller concessions, these should be verified, reported and adjusted for in the appraisal," she said. "Even if a property sold high due to the concessions, with the appraisal supporting the contract price, appraisers should deduct these concessions from the sales price when using it as a comp."

It can be a challenge for appraisers because too often seller concessions aren't listed in the MLS. One solution could be to make reporting seller concessions mandatory in the multiple listing services. The appraisal industry, as a result, may need the help of the real estate industry for that to become a reality.

"The concessions are almost as important as the listing of the sales price, since some prices have been increased substantially just to allow for concessions," Coon pointed out. "The appraisers are having a tough time tracking these down."

### USPAP requirements

Appraisers also are required by USPAP, Fannie Mae, Freddie Mac and the government agencies to properly verify report and adjust for seller concessions.

When it comes down to it, appraisers can be held accountable for an appraisal if the value is inflated as a result of concessions. The remaining problem is that such data is hard to get, especially for the comparables.

The reason seller concessions are so tricky to uncover is because they generally are built into the contract price so they will be included in the loan.

That is where the issue of pressure on appraisers becomes an issue. Valuation professionals are frequently pressured to support the contract price. Many are hesitant to come in below the contract price in a new home development for fear again of not getting any more assignments.

"The appraiser must make appropriate adjustments for differences and indicate the dollar amount of the adjustments to reflect the value of the differences to the market."

— *Jacqueline Doty, director of collateral policy, Freddie Mac*

"When you add in the pressure issue to the fact that seller concession data is not reported and the appraisers can get into trouble by not handling concessions properly, you put appraisers in an impossible position," Coon said.

Appraisers are pressured to hit values and turn assignments around so quickly, that many valuation professionals may not have the time to adequately review all of the sales contracts and comparable sales for the potential land mines that concessions can pose.

### Muddying the water

There also is a level of confusion, as appraisers frequently are left to scratch their head over how to handle concessions.

Coon told *Valuation Review* that some appraisers misinterpret the word "typical" as it is used in the definition of market value.

"They think that a lot of sellers are paying concessions, especially from new home builders in the same neighborhood," she said. "They are viewing these concessions as 'typical' and aren't deducting them."

It is an incorrect assumption and Fannie Mae and FHA have both tried to clarify the instructions to the appraisers. The concessions that increase the sales price should be deducted when the sales are used as comps.

In performing their due diligence, Doty said appraisers must analyze each comparable sale for similarities and differences between it and the subject.

"The appraiser must make appropriate adjustments for differences and indicate the dollar amount of the adjustments to reflect the value of the differences to the market," she said. "Comparable sales must be adjusted to the subject property, except for sales and financing concessions that must be adjusted to the market at the time of the sale."

It should be noted that the appraiser must independently verify and analyze all pending and recent sales of comparable properties, report how the sales were verified and whether concessions were granted. At least three verified, closed (settled) sales of comparable properties must be analyzed and market-based adjustments made for significant differences between the comparable sales and the subject property.

### The ripple effect

Like a snowball rolling down a hill, seller concessions included in a contract price can have a compounding impact if the appraisal supports the contract price.

The bloated sale prices have a chain reaction throughout a neighborhood. They will result in inflated asking prices and when they are used as comparable sales in other appraisals without proper deduction, the result is another inflated

■ See CONCESSIONS on Page 8

**CONCESSIONS** — continued from Page 7

appraisal supporting an inflated contract price.

> "What is happening in many markets, is the perception and pressure that the appraisal should conclude at or near the 'contract price,' which will include the concessions."
>
> — *Elizabeth Kern, president, NAIFA*

### Tripping up appraisers

These concessions really can be viewed as land mines because the lenders, secondary market and investors don't see them, so therefore they have no idea how many appraisals reflect inflated values.

"The consumers also end up being hurt by the inflated price paid for their home," Coon pointed out. "They can end up with higher property taxes, as can the rest of the neighborhood. It is ironic because these are the same consumers that needed help to buy their homes."

Concessions do serve a legitimate purpose because there are a number of worthwhile programs that help individuals to purchase a home.

"There just has to be a better way," Coon said. "The assistance of concessions shouldn't be confused with market value."

The industry does permit sales concessions when loans are originated without restrictions against inclusion in the sales contract.

Nonetheless, allowing seller concessions to be built into a contract price and mandating that the appraiser consider them in the home's value confuses the appraiser and sends a contradictory message.

"Including the concessions in the contract price also means that the appraised value will likely not meet that price," according to Coon. "Or, if the sale takes place with those concessions, the appraiser must later deduct those costs from the price of the comparables. As an appraiser, you just can't win."

Because the effect of concessions on sale prices can vary with the type and amount of the concessions, Doty pointed out that any adjustments to comparable sales must be based on the market reaction to them.

"The appraiser should provide comparable sales that sold without concessions to support the adjustments made in determining the market reaction to the concessions," she said. "Adjustments may not be based solely on dollar-for-dollar deductions equal to the dollar value of the concessions."

### Making the adjustments

Doty also noted that if comparable sales without concessions are not available, adjustments to comparable sales with concessions must reflect the differences between what the comparable sales actually sold for with the concessions and what they would have sold for without the concessions.

"The appraiser's opinion of value must reflect the value of the subject property without the concessions," she added. "The appraiser must also provide the dollar value of the concessions as a comment in the appraisal report."

To resolve the problem, there may need to be cooperation from the entire industry, from appraisal organizations, the GSEs, the National Association of Realtors and consumer groups to seek a solution that will permit assistance without distorting market value.

A simple idea, according to Coon would be to prohibit inclusion of financing concessions in the sales contract.

"The contracts should consist of the price paid for the real estate only, not the financial incentives," she said.

All of the incentives to aid buyers should be done as an agreement separate from the purchase transaction of the real estate.

### A possible solution

"Mandating that financing concessions be omitted from the sales price in the contract presents no downside to the lending industry," Coon added. "Using this method, the concessions would still be allowed to help borrowers obtain loans, but would not impact the true value of the real estate by confusing appraisers and obscuring values."

Such a proposal could have a number of positive effects, including the fact that it would reduce inflated prices paid for real estate; stop the corruption of databases by sales inflated by concessions; increase accurate analysis of the basis for loans; and increase the accuracy of appraisals.

Additionally, first-time buyers and others in need of homeownership wouldn't find themselves "upside down" in a loan. On top of that, the overall magnitude of concessions is tough to gauge.

"If the financial community in general knew how prevalent concessions are, and how much they are affecting valuations, this problem would be addressed," Coon said. "As of now, financing concessions remain land mines for lenders."

*Feedback? Contact **David Hutton** at dhutton@octoberresearch.com.* ∎