PVD Foreclosure Related Sales Guidelines

Introduction

The purpose of this paper is to provide guidance to county appraisers in dealing with the high volume of foreclosure related sales, also known as REO's (real estate owned by a financial institution), as a result of current economic conditions. The use of these sales in estimating market value is a critical problem facing assessing professionals today. The commonly accepted definition of market value precludes the use of sales subject to undue stimuli; however, many if not all foreclosure-related sales potentially have been subjected to undue stimuli. Despite this issue, when such sales affect the market, they should be validated and evaluated to determine their impact on the local market. If an impact is clearly discerned, such sales should be included for the neighborhood or market area for market modeling.

Definition of Terms

- **Financial institution sale of real estate owned *(REO)***
  A sale of property that has been foreclosed on by the financial institution (the seller will be a financial institution). These properties may also be called 'other real estate owned' (OREO) sales.
- **Foreclosure**
  The legal proceedings initiated by a creditor to repossess the collateral for a loan that is in default; the legal proceedings in which a mortgagee, or other lienholder, usually a lender, obtains a court ordered termination of a mortgagor's equitable right of redemption; the legal process by which a lien against property is enforced through the taking and selling of the property.
- **In-Lieu-of Foreclosure**
  Property transferred back to the mortgage lender prior to foreclosure proceedings.
- **Sale**
  The state of being purchasable; offered or exhibited for selling; an agreement (or contract) in which property is transferred from the seller (grantor) to the buyer (grantee) for a fixed price in money (paid or agreed to be paid by the buyer)
- **Short Sale**
  A bank or mortgage lender (financial institution) agrees to discount a portion of the loan balance due to an economic or financial hardship on the part of the owner (mortgagor); a property sale negotiated with a mortgage company in which a lender takes less than the total amount due. Unless the seller receives a letter from the lending institution that states *without recourse* the lending institution may in the future attempt to retrieve the additional amount of the mortgage owed from the seller.

The terms are described below.

<u>Foreclosure</u>
The financial institution is taking back a property because of default of the loan. This is not a sale.

<u>In Lieu of Foreclosure</u>
The property has been transferred to the mortgage lender prior to a foreclosure proceeding. This is not a sale.

<u>Short Sale</u>
A buyer makes an offer to a seller for less than the outstanding mortgage balance and the bank accepts. While being a distressed sale, the names on the Sales Validation Questionnaire do not reflect a financial institution. Often, the financial institution will agree to the lower sale price to forego the foreclosure process. The MLS may indicate *short sale* but most often they are unidentifiable without additional research. If the traditional market is affected by such sales, they should be considered in market modeling and ratio study analysis.

Financial Institution

<u>Financial Institution sale of a formerly foreclosed on property *(REO)*</u>
The financial institution sells a property obtained through a foreclosure. If the sale meets the definition of an open-market arm's-length transaction, it should be included as a valid transaction for market modeling and ratio study analysis if this type sale has an influence in certain market areas or neighborhoods.

Foreclosure Related Sales Verification and Documentation Process

Historically, financial institution sales were typically discarded during the sales validation process. Due to the current economic crisis, these sales should no longer be ignored for market modeling and/or sales ratio analysis in areas where they are prevalent.

In a highly depressed market where there are a significant number of financial institution sales (REO's) and or other foreclosure related sales (such as short sales) the consideration for inclusion of these sales becomes even more critical. Their impact must be evaluated if the following circumstances apply.

- Foreclosure related sales affect the value of typical sales in the area
- Foreclosure related sales are the only properties selling in the area

These sales may be so numerous that non-distressed sellers in the area are forced to lower asking prices in order to sell their property. If this is the case, foreclosure related sales have become a significant influence in the market or perhaps "the market". In some instances it may take the conventional real estate market time to fully reflect the impact of these sales. In these areas a negative time trend may be applied to the annual ratio study. A trend request and supporting documentation can be provided to PVD for review and consideration.

The county must determine whether foreclosure related sales should be considered for valuation modeling, especially when the number of foreclosure related sales is substantial and the affect on market value may be measurable. Failure to recognize and consider these sales may cause inflated valuations and an unprecedented number of appeals during the informal and formal hearing process. Including foreclosure-related sales when the conventional market does not indicate any influence, could result in the under-valuation of property.

Prior to including a foreclosure related sale as a valid transaction for either market modeling or ratio study analysis, answers to several questions must be researched.

- Was the property exposed on the open market?
- Were there substantial changes to the property characteristics?

- Were there any circumstances that might cause the sale to be considered a non-arm's-length transaction?

The seller (the financial institution for REO property) will be the party most knowledgeable in providing answers to these questions.

By developing a basic set of interview questions when researching sales, these transfers can be thoroughly screened and validated.

- Exactly how was the property marketed?
  (Listed with a real estate agency, word-of-mouth, newspaper ad, for sale signs, Internet posting, auction, etc). Foreclosure related sales where the property is only offered to a select list of buyers do not meet the definition of an open market transaction.

- How long was the property exposed on the open market?
  It is important to obtain the amount of time the property was exposed to the open market. Typically, when a property is listed and sold on the same day, the lending institution or real estate agent already has a specific buyer in mind. These sales should never be included as a valid transaction. The appraiser should determine the *typical* exposure time in neighborhoods or market areas.

- What was the asking and selling price?
  Large differences between the asking price and sale price can indicate a distressed sale. For example, the sale price may be significantly lower than the original asking price because bank regulators ordered the property to be disposed of, regardless of the outstanding mortgage balance. In a short sale the property owner may have attempted to sell the property at a substantially higher asking price for quite some time. When the seller runs out of time and foreclosure is eminent a low-ball offer may be made by a buyer for less than the outstanding mortgage amount. The lending institution can either accept the low-ball offer or reject it and begin the prolonged and costly foreclosure process.

- What was the condition of the property and did any substantial changes in the property characteristics occur recently?

  Condition of the property at the time of sale is extremely important. Some owners going through the foreclosure process may defer maintenance or destroy the interior of the building prior to being evicted. Foreclosed homes on the market may be vandalized after they are vacated. It is important to determine the extent of the damage (change prior to the sale) since the last appraisal cycle. If the dollar amount is substantial *(greater than five to ten percent of the total sale price)*, the sale will not be included as a valid transaction for the state's ratio study because the property is no longer a reflection of the property appraised on January 1st. However, changes to the property should be considered by the county appraiser for future valuation cycles.

- Was any personal property included in the sale price, and if so, was the personal property listed separately in the bill of sale or the purchase agreement?

  In some cases former owners leave significant amounts of personal property (furnishings and appliances) behind which may or may not be removed from the property by the lending institution prior to the sale.

  The *Standard on Ratio Studies* [IAAO 2007] states that properties typically sell with refrigerators, ranges, and draperies and an adjustment is not required unless specifically broken out in the contract. If additional personal property is included in the sale price and the amount is known and is considered substantial, an adjustment must be made prior to using the sale (total sale price minus personal property value). However, if the personal property amount appears to be substantial (*greater than five percent)* and a the value cannot be determined, the sale should not be considered for use.

- Are there any other factors that may cause the sale not to be an arm's-length transaction? The *Standard on Ratio Studies* [IAAO, 2007) provides a comprehensive list of circumstances that can influence the validation decision. These may require additional verification work prior to categorizing the sale as valid.

Complete and thorough written documentation of these foreclosure related sales is extremely important to support validity decisions for both modeling and ratio study analysis. It is strongly recommended that a comprehensive documentation process be developed and implemented by the county. Records and forms may be stored in either in paper or electronic format *(most Kansas Counties have already incorporated comprehensive documentation records into their sales verification process)*. The documentation forms should be completed at the time of verification. A well-designed form will prove invaluable in documenting the circumstances surrounding the transfer and supporting the validity decision for each foreclosure related sale. In addition, a comprehensive set of written guidelines along with additional training should be provided to staff assigned to validating and screening sales.

For computer assisted mass appraisal systems and ratio study programs, specific codes should be assigned to clearly identify foreclosure related sales. This will provide the flexibility to include or extract sale data for future analysis. This may also be helpful when the economy eases back into more stable market equilibrium.

Equity Measurement *(COD)*

Some areas have experienced a mix of typical market sales along with a substantial number of foreclosure related sales. If the market has not fully responded to the foreclosure related sales, the equity measurement recommended by IAAO, Coefficient of Dispersion *(COD),* may fall out of compliance.

Official State Ratio Study

Property Valuation will work closely with local jurisdictions during this economic cycle to ensure foreclosure related sales are considered in areas where they influence market value.

Foreclosure related sales will not automatically be included as potential valid transactions in the official state ratio study. If the county has included foreclosure related sales in their market modeling process, documentation should be provided to PVD to identify the neighborhood or market areas affected. Documentation may be submitted during the informal hearing process. PVD will extract all foreclosure related sales for the neighborhood or market area from the sales database and reprocess them prior to completing the final ratio study. For residential sampling counties in large counties, all foreclosure related sales that have been sampled from such neighborhoods or market areas, but were not included as valid transactions are identified. These can be reprocessed if the county appraiser makes a case for inclusion. PVD is currently identifying foreclosure known related sales with unique validation codes.