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APB VALUATION ADVISORY 3: RESIDENTIAL APPRAISING IN A DECLINING MARKET

APPRAISAL PRACTICES BOARD

THE APPRAISAL FOUNDATION

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APB Valuation Advisory #3:

Residential Appraising in a Declining Market

This communication is for the purpose of issuing guidance on recognized valuation methods and techniques. Compliance with such guidance is voluntary, unless mandated through applicable law, regulation, or policy.

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Application: Residential Real Property

Issue: As part of its ongoing responsibilities, the APB is tasked with identifying issues where appraisers and appraisal users believe additional guidance is required. One such issue identified by the APB is residential appraising in a declining market. This publication will attempt to provide additional guidance as to generally accepted methods and techniques for appraisers to review when developing and reporting real estate appraisals in declining markets.

While some appraisers may think this document is providing instructions on the correct way to perform an analysis and draw conclusions, it is not. It is providing additional guidance on generally accepted methods and techniques. There may be other methods and techniques that have not been discussed here. The practitioner that uses other techniques should be able to present and support the logic of their analysis. Practitioners that incorporate the information from this publication must understand and be able to utilize these techniques to provide credible results.

Subject Matter Experts: The Appraisal Practices Board and The Appraisal Foundation wish to express our sincere gratitude to each of the following Subject Matter Experts for volunteering their time and expertise in contributing to this document:

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Executive Summary

Many appraisers and users of appraisal services have raised important questions regarding appraisals prepared in declining markets. Some of the questions that have been asked include:

I. How should an appraiser define a declining market? What has to happen in a market for an appraiser to designate it declining?

Defining a declining market is difficult. Many appraisers and users of appraisal services differ on what constitutes a declining market. This document suggests that it is incumbent on the appraiser to develop the definition of a declining market or obtain a supportable definition from a legitimate source, preferably not the client. Regardless of how the definition is obtained the appraiser should state and illustrate what the term declining market means in the context of the appraisal report. Credibility is added by citing the evidence upon which the conclusion is based.

II. What databases or publications are available to help an appraiser support an opinion of market trends?

Many appraisers find it difficult to support their opinions of market trends because of lack of retrievable and verifiable market data; often the quantity of comparable sales does not support statistical analysis. National, regional or local databases can be used to support evidence of market trends.

Databases – While the types of databases listed in this document are used by many appraisers, others are available and may be equally or more relevant to appraisers' work. Some residential databases can present sophisticated analysis as part of their programs. The appraiser must be careful to read the background information of any database considered to at least understand about possible biases and if the bias is too great, to eliminate the data. Users of secondary data must understand the process of collecting and analyzing the data to ensure the use of the information is applicable in an appraisal. This means appraisers are responsible for knowing the source, applicability, and reasonableness of the data and analysis prepared by others that is presented in their appraisal reports.

Most clients do not ask residential appraisers to perform significantly detailed market analyses (scope of work). However, clients are asking appraisers to indicate if markets are declining, increasing or stable. Support for such conclusions can be accomplished with numerous methods. Section II is not intended to eliminate other valid tools used by appraisers but does suggest that any other tools utilized be tested against other methodologies to ensure their validity.

III. If a client instructs an appraiser to include, or exclude, data from short sales or REO comparables, does that comply with the definition of value in the report? Besides market value, what other defined values could an appraiser use?

Clients can stipulate conditions on appraisal development but even if asked, appraisers cannot develop or report misleading analyses, opinions, or conclusions.

Other value terms that are used in practice include:

- Disposition value
- Liquidation value
- Other client-defined terms including durable value and foreclosure value

Clients can stipulate conditions on appraisal development but they cannot ask an appraiser to develop and report a misleading analysis or assignment results. If the client stipulates the inclusion or not of a particular type of comparable, the appraiser may have to revisit, with the client, the type of value developed.

IV. When labeling a market as declining, should the appraiser limit the criteria to an area equal to the neighborhood, or should a market study include a larger or smaller geographical area?

A neighborhood is a grouping of complementary land uses. This is a geographically defined term and therefore could include residential, commercial and even industrial uses within the neighborhood. A market study is focused on competing properties; therefore a market analysis need not have the same geographic limits as the neighborhood. When defining a market it is important to use parameters that include competing properties and exclude noncompetitive properties. The market area may be more important than the neighborhood.

V. Is it an appraiser's responsibility to verify data used in an appraisal? Should an appraiser know what the primary motivations were of the buyers of each comparable?

If an appraiser is developing an opinion of market value it is necessary to decide who the most likely type of buyer would be. In some markets, the most likely buyer is an investor who requires an entrepreneurial incentive and in other markets the most likely buyer is an owner/user who decides what property to purchase based on his or her specific needs. Determining the most likely type of buyer requires data verification, which is also required by USPAP.

The intended use of the appraisal, based on communication with the client, influences the type and definition of value to be used in the assignment, which in turn guides the selection of comparable transactions.

VI. In declining markets where appraisers need to adjust for differences in buyer motivations, may an appraiser make condition-of-sale adjustments? What are reasonable methods for supporting adjustments in declining markets for conditions of sale?

Appraisers can use condition-of-sale adjustments to compensate for the motivations of the participants in the sale. If the most likely buyer is an investor, it *may* be necessary to adjust for the required entrepreneurial incentive. When using secondary market appraisal forms the appraiser should account for conditions of sale (although this applies in *any* market, not just those that are declining).

Four generally-accepted techniques may be utilized to support adjustments in appraisals. These techniques include the following:

- Extraction from comparable sales also known as paired sales analysis.
- Depreciated cost – Cost of construction less all applicable depreciation.
- Income capitalization – If rental differences reflect the market adjustments.
- Buyer interviews – If truthful answers can be obtained, this technique most clearly mirrors market reaction to a feature or an arrangement.

In declining markets, the most commonly-used technique for supporting condition-of-sale adjustments is extraction from comparable sales. This is often done by paired-sales analysis.

VII. Integration of the Opinion of Market Trends into the Appraisal Analysis

In many appraisal analyses, the only need for adjustment for declining markets is in the cost approach (in the form of external obsolescence). In most circumstances, an appraiser that uses comparable sales from the same market as the subject should already reflect market conditions. The income approach should already reflect a weak market because of lower rental rates and lower gross rent multipliers.

VIII. In declining markets, what statistical tools are available to support adjustments and rates of change in market conditions?

More and more statistical tools are becoming available to appraisers and valuation companies. While development of Automated Valuation Models (AVM) or Computer Assisted Mass-Appraisal (CAMA) may be most closely associated with large firms with considerable assets, current technology and databases allow appraiser-practitioners to access and develop their own statistical tools to support opinions about market trends.

IX. In conclusion, when appraising during a period of declining markets:

1. It is incumbent on the appraiser to develop or adopt a supported definition for a declining market, and to support a conclusion of that decline in his or her appraisal;

2. Several sources of data are available to support conclusions of declining values;

3. In addition to market value, numerous definitions of value exist; one or more of these other definitions may better describe the nature of competitive transactions in the relevant marketplace and meet the client's needs;

4. The market area may be more relevant for the collection and analysis of trend data;

5. Verification with one or more of the parties to the transaction will be needed to understand the motivations of market participants and to enable forming a conclusion of the likely buyer type as a subset of the highest and best use conclusion; this in turn influences the selection of the value definition (in conjunction with communication with the client), which in turn guides the selection of comparable transactions;

6. Supported adjustments should be made where necessary for condition-of-sale adjustments in declining markets; and

7. Statistical methods may offer a way to support a variety of adjustments.

[End of **Executive Summary**]

I. How Should an Appraiser Define a Declining Market?

When providing residential appraisal services, appraisers may be required to determine what constitutes a declining market in order to produce credible assignment results. When determining the status of a market, issues of concern include the following:

- Currently, there is no single, commonly-accepted definition of a declining market.
- How are "normal" increases and decreases in the market (caused by seasonal differences or temporary over or undersupply of inventory) considered when determining the status of a market? How are those seasonal market movements differentiated from a declining market trend?
- Should an appraiser declare the subject to be in a declining market if, for example, the median price in the market falls for one quarter, or would the median price (in this example) need to fall for two or three quarters before calling the market declining?
- When an appraiser indicates that values are declining, does that mean they are declining as of the effective date of the appraisal, or does it imply prices will decline in some future time period?

Recognizing characteristics and identifying declining markets. Identifying market cycles and the position of the subject within that cycle.

Recognizing the characteristics of a declining market – Most appraisers can identify the indicators of a declining market. However, many have trouble interpreting the indicators and then deciding when the indicators lead to a conclusive identification of a declining market. Some characteristics of a declining market are as follows:

- Oversupply of competing properties (i.e., demand and supply are out of balance).
- Extended marketing times for active, pending and closed sales.
- Prior listings of the subject that reflect list prices notably higher than the current contract, sale price or value.
- Prior sales of the subject and/or comparables that reflect higher prices than current prices.
- Decrease in sale prices as a percent of list prices.
- Increase in REO listings in neighborhood.

In most cases, one of these characteristics alone is not an indication of a declining market, but the presence of several indicators may be a strong indication that the market is in decline.

Defining a declining market – It could be said that all markets are increasing if you go back in history far enough. If an appraiser looks only at the last two quarters, would this be a reasonable time period to say whether prices are going up or down? Would it be better to say in the last 90 days? Would it be better to analyze and read the current market on an annual basis because of the impact of normal seasonal differences?

It is quite logical to say "Declining; compared to what?" It is important for an appraiser to not only state whether they believe the market for the subject is increasing, decreasing or in balance, and to also state what baseline was utilized to arrive at that conclusion. The appraiser should tell the intended users what the comparison is based on (e.g., “The subject’s market is considered to be increasing compared to the same market a year ago,” or “This market is considered to be declining because the database shows a decline in median prices for three out of four quarters in the last year.”)

Just stating “increasing,” “declining” or “stable” without commenting on the time period covered is inadequate. For example:

> The subject is in a residential market where the climate is not conducive to sales of residential real estate in the first quarter of each year and sales volume and median prices normally fall at that time. Usually prices and sales volume increase in the second quarter once the temperatures are milder. For example, the appraiser looks at the median prices for the prior quarter and sees a decline of 15%; however, the appraiser also sees an increase of 10% compared with the same quarter of the prior year. This appraiser indicates this market is increasing based on that data and states the logic behind the conclusion.

Client-Defined Term – It is possible that the appraiser will have an assignment where the *client* defines the term “declining market.” If a client defines this term, the appraiser should include that definition in the report and be sure to explain what it means and report the source of the definition. The appraiser cannot accept client-defined terms that will produce misleading assignment results. Concluding that a market is declining (or stable or increasing) is the responsibility of the appraiser.

Consistency within the Appraisal – It is also important for an appraiser who states that property values are declining to be consistent with the market conditions adjustments in the sales comparison analysis. In other words, if the appraiser states that prices are declining, negative market condition adjustments would be warranted, or an explanation as to why they were not warranted would be appropriate.

Current condition or prediction of the future. It is important to note that in most appraisal reports the market analysis represents a historic view, not a forecast of the future market. The appraiser may elect to advise the client on future risks associated with the investment but that is not the same as a forecast of the future markets. While most appraisers are reluctant to forecast future market behavior and present information not intended to forecast future market behavior, it does not necessarily mean the intended users understand that in the data presented. It would behoove an appraiser to state that market conditions labels are historic and are not a forecast of future markets. For example:

- “The market analysis contained herein is a summary of past market conditions which may or may not be a reflection of future markets”; or
- “The conclusion listed above is based on empirical evidence but that evidence may only reflect the past not the future.”

II. What Databases are Available to Support a Market Trend Conclusion?

Many appraisers find it difficult to support their opinions of market trends because of lack of retrievable and verifiable market data; often the quantity of comparable sales does not support statistical analysis. There are national, regional or local databases that can be used to support an opinion of market trends.

Databases – While the types of databases listed below are used by many appraisers, other databases may also be used. Some databases may be equally or more relevant to appraisers' work. Some residential databases can produce sophisticated analysis as part of their programs. Care must be taken to read the background information of any database considered to at least know about possible biases or to eliminate the data from consideration if the bias is too great. It is important for users of secondary data to understand the process of collecting and analyzing the data to ensure the use of the information is applicable in an appraisal. This means the appraiser is responsible for knowing the source, applicability, and reasonableness of the data and analysis prepared by others but presented in their appraisal report.

Popular National Indices. Several popular national residential price indices can be used by appraisers to support their analysis of market trends. Each index has strengths and weaknesses and should not be used these without an understanding of the source of data and methodology of the analysis. If the index is based on tracking the median price, the median price could be pushed upward or downward because one market segment has more volume but not necessarily higher prices. For example:

> A suburban residential market in an urban area experienced a substantial increase in the number of sales at the low end of the price range due to a local stimulus plan for first time buyers. This caused the low end of market to have many more sales than the upper end of the market which pulled the median price down, not because prices were lower but only because there were more sales at the low end. It is important for appraisers to understand the nuances of the data and analysis they are using in the appraisal that was obtained from others.

Repeat Sales Methodology **–** These indices are widely considered to be the most accurate way to measure price changes for real estate. The repeat sales methodology measures the movement in the price of single-family homes by collecting data on actual sale prices of single-family homes in their specific regions. When a home is resold, months or years later, the new sale price is matched to its first sale price. These two data points are called a "sale pair." The difference in the sale pair is measured and recorded. All the sales pairs in a region are then aggregated into one index. Sales pairs should be carefully screened for any data points that would distort the index, such as non-arms-length transactions.

Federal Housing Agencies – Federal agencies that are involved in the sales and/or mortgage refinances of residential real estate in the U.S. keep statistics on the sales that they are involved with, but also track refinance appraisal values. The use of refinance appraisals as indications of value is arguable, but, if the risks of using "opinions" in lieu of "sale" data are known, the analyst can use it even with the possible bias.

Hedonic Index – An alternative to the median-price index and the repeat-sales index is what economists call a hedonic index, which uses information from hedonic regression. A hedonic index uses information on the details of the property (gross living area, bedrooms, style, location, etc.) to estimate the value of the property. Because it does not require a prior sale price, all of the sale data (vs. repeat sales) each period can be used to produce the index.

Local Databases – The previously listed databases are easily obtained and incorporated into reports by appraisers (with attribution) but many may not be very local. They may represent large areas with all price segments included.

If available, appraisers can use their own local databases (e.g., MLS system) to develop some statistical indications of market trends for a small area as needed and that represent only competing properties. Many MLS systems have some predesigned analysis that can be extracted directly from the MLS computers. These will oftentimes have premade graphs, tables and measures of central tendency of the user defined market. Appraisers who use these predesigned market analyses are responsible to ensure they are representative of the subject's market and are not misleading.

Other Tools to Measure the Market – It is possible to prepare other statistical models, or to simply track data in a market. When these analyses are used, they should be relevant and not misleading. Appraisers in markets where there is insufficient data to draw statistical inferences should not present inadequate and therefore potentially misleading exhibits with less-than-adequate data or significantly-biased analysis.

Examples of other market analyses used by appraisers are:

1. Tracking the median sale prices in a defined market segment over time (e.g., 1004 MC form).
2. Researching and calculation of rates of change from sales and resales of the same properties.
3. Tracking over time of the Days on Market (DOM) of comparable listings or comparable sales.
4. Tracking over time of sale price to list price ratios (SP/LP). The assumption is that the greater the discounts from list price, the more motivated the sellers are.

Most clients do not ask residential appraisers to perform significantly detailed market analyses (scope of work). Clients are asking appraisers to indicate if the markets are declining, increasing or stable. This can be done with numerous methods and Section II is not intended to eliminate other valid tools used by appraisers. It does suggest that any other tools need to be tested against other methodologies to ensure validity.

III. What are Some Alternative Value Definitions?

Some appraisers have expressed difficulties in obtaining clear guidance from their clients or from secondary market participants on the correct meaning of terms and applicability of different value definitions. Some clients ask for "market value" but don't define or understand the term. Some clients want to adjust the appraisal conclusion by stipulating terms in the analysis (e.g., a sale within 30 days). This usually results in a variance from the commonly-used definitions of value and the appraiser must then define the term within the document to ensure the client and intended users understand what type of value is conveyed in the report.

Most value definitions are provided to appraisers within the customary forms (e.g., URAR). Some terms in common use today include market value, liquidation value, disposition value, distress sale, forced sale, forced price, short sale, foreclosures, etc. Other literature may reveal additional terms of importance. (Many are reprinted within the *Glossary of Terms* at the end of this paper.)

Market Value: The Public Perception – It is important to understand that most real estate owners, lenders, investors and government officials believe that the term "market value" reflects a gross sale price that an owner of the subject would receive if the subject were put on the market as of the effective date of appraisal. This assumes exposure time has already occurred. However, it is widely recognized (including in USPAP) that market value definitions assume a hypothetical sale of the property as of the date of the appraisal according to the standards of the definition of market value utilized in the appraisal.

In most definitions, market value assumes a sale to the most probable buyer within the highest and best use opinion. This means the definition of the term is based on a sale from the current owner to a new owner. When an appraiser is asked for a "Market Value Opinion," the public perception would be that the appraiser will tell the client how much they can sell it for. If so, this necessitates an understanding by the appraiser and the client that the value is a future value. This also necessitates an opinion of "the most probable type of buyer."

Because comparable sales are used to develop opinions of market value, the comparable sales must be compliant with the defined value or be adjusted to those requirements. There are many parts to the popular definitions of market value including the condition that "(1) buyer and seller are typically motivated;" Some appraisers consider that this condition in the defined value precludes using comparable sales that were bank owned properties, short sales, or even corporate relocations. While this may be possible in some markets, this cannot be done in many other markets. There are markets where nearly all sales are bank-owned, short sales or other financially distressed sellers. To say these are excluded fails in two ways:

> (1) It precludes doing any market value appraisal in these markets with nearly all bank owned properties sales unless significant adjustments are made to bring the sales up to a perceived level where the "normal market" would be. The ambiguity of the term "normal market" leaves too much room for debate; and
>
> (2) It ignores the public and institutional perception of the words "Market Value." These terms are seldom argued by people outside the appraisal profession. They are assumed to mean that the value opinion is the amount an appraiser thinks a property would have sold for on the effective date of appraisal.

This is why communication with the client about the intended use and scope of work is important to ensure the appraiser does not answer the wrong question.

Client Expectations – To avoid misunderstandings between the client and the appraiser, it is important at the time of engagement to discuss the type and definition of value to be developed, to ensure that the type of value developed is consistent with the client's expectations. Appraisers should match the intended use of the appraisal with the defined value and consider each aspect of the defined value. For example:

> An appraiser is asked to use residential comparable sales to provide an opinion of value on a property that has a highest and best use as commercial land. The client says, "Value it as a residence and ignore the commercial land value." If the appraiser agrees to do this, this appraisal has shifted from market value (commercial) to value-in-use (residential).

Some terms that may be significant in this issue are listed below and defined in the *Glossary of Terms*.

1. **Disposition Value –** This is a defined value that can be used by appraisers and clients who are attempting to find a value that represents a particular need. The defined value includes the following conditions:

    - Consummation of a sale within a future exposure time specified by the client.
    - The property is subjected to market conditions prevailing as of the date of valuation.
    - Both the buyer and seller are acting prudently and knowledgeably.
    - The seller is under compulsion to sell.

    The consummation of a sale with exposure time specified by the client is a key term in this definition. The appraiser needs to ask the client what to assume, including how much exposure time is to be assumed for the hypothetical sale that occurs as of the effective date. The seller is under compulsion to sell, which is not much different than many sales where the seller has already bought another property or needs to sell an investment that is of no value to them. Would a sale by a lender of a foreclosed property constitute a "disposition sale" and not a market value sale? What about the sale of a corporate relocation? Did the property sell within the time specified by the client? If a client asks for this defined value, the scope of work and the methodology for developing this opinion of value must be understood and reported. For a complete definition of these terms and others that follow, please see the *Glossary of Terms* at the rear of this document.

2. **Foreclosure sale –** This is the sale of a property ordered by the court and/or process of law, where the seller is ordered to sell the property at auction or by other means to satisfy the mortgage against that property. In many states, this is called a "sheriff's sale."

3. **Liquidation Value –** This definition is different than the standard market value definition because it assumes:

    1. Actual market conditions currently prevailing are those to which the appraised property interest is subject;
    2. The seller is under extreme compulsion to sell; and
    3. A limited marketing effort and time will be allowed for the completion of a sale.

    Again, the methodology and defined terms should be reported by the appraiser to prevent misunderstanding what the results are and how they are supported. Did the appraiser discount "Market sales" to reflect the required discount or did the appraiser find some "Liquidation Value sales"? This definition does not coincide well with bank-owned foreclosure sales because it requires a limited marketing effort and limited time to complete the sale. A common complaint for bank owned properties is not the short time allowed but the length of time required to close the sale. Most bank-owned properties are listed for sale with the same real estate brokers as the non-bank owned properties.

4. **Market Value –** This is the standard definition used in most residential appraisals. There are other value definitions used for relocation and condemnation appraisals. This definition refers to a "fair sale" without "undue stimulus." This definition is based on a transaction occurring under typical market conditions.

5. **Other Values –** Clients may modify existing defined values to suit their current needs. If an appraiser is asked to use an alternative definition, the appraiser must include that defined value in the report and cite the source of the definition; if another defined, cited value is also included in the report, the appraiser must be clear what definition is being used in conjunction with each value opinion.

More than One Defined Value – Appraisers may be asked to provide more than one type of value in an assignment. Appraisers should also remember that if they are conveying a value opinion other than market value, the use of standard secondary market forms requires caution. These forms have incorporated the definition of "Market Value" into the form. If an appraiser were asked for "Liquidation Value," it may be necessary to utilize something other than a preprinted form and include the type and definition of value being utilized. In most cases, preprinted secondary mortgage market forms do not offer an option of a different defined value. It is possible for appraisers to add a second defined value in the report and then give the client two value opinions (e.g., market value and liquidation value). However, both values must be defined within the report and the report cannot be misleading, which would be in violation of USPAP.

IV. Defining a Market vs. a Neighborhood

Some clients, investors and bank officers are finding it difficult to understand appraisers' delineation of neighborhoods, markets or competing properties. Some appraisers consider the market and the neighborhood to be the same geography while others believe geographic delineations may, and oftentimes do, contain more than one market segment (e.g., a golf course community may have one market with properties adjacent to the golf course but another market with properties further off the course). It is possible to define the neighborhood as the entire project but the markets are defined by the view amenity.

Identify the subject market area and competing market areas. It is important for an appraiser to know what the competing market is before deciding if the values are declining. This requires the appraiser to consider and analyze who the most probable buyer is and their purchasing criteria. This requires highest and best use analysis and basic knowledge of buyer behavior.

Designing an analysis. When designing a market analysis, the data search must be designed to represent the subject's market segment. For instance, a market analysis used in a single-unit detached home appraisal that reflects the condominium market in a city will probably yield flawed conclusions. An understanding of the following terms, which are defined in the *Glossary of Terms,* is required to develop a proper analysis:

1. ***Market*** **–** For residential appraisers, this could mean the single-unit residential market or the four-unit residential market. It need not necessarily have narrowly-defined geography. It could be a city-wide market or maybe just a one-mile square. For example, the condominium market in Bigville.
2. ***Market Area*** **–** The geographic area that includes competition for the subject property. Geography is more significant in this term. The direct competition could by city-wide but commonly will be a smaller area (e.g., the northeast-city single-unit residential market).
3. ***Market segmentation*** **–** This term describes the process of delineating a market in buyer-specific criteria. This is necessary to prevent comparing a four-bedroom market with a two-bedroom subject. Market segmentation in residential properties could be school or taxing districts, number of bedrooms, number of floor levels, garage space, age of improvements and site size.
4. ***Neighborhood*** **–** This is another defined area focused on geographic limitations. It refers to a "grouping of complementary land uses." This term implies that a neighborhood could include more than just single unit residences and could include apartment projects, commercial and even industrial land uses in some cases. This long-standing definition is why neighborhoods and markets are not necessarily the same.

Defining a Market Area – Appraisers must define the subject's market area before they can draw conclusions about that market. A neighborhood is defined geographically by the appraiser based on consideration of what owners and buyers think are geographic commonalities. The market is defined in terms of geography but also price range and buyer preferences (size, age, design of improvement, lot size, etc.).

It is quite possible for a neighborhood (grouping of complementary land uses) to be only a platted subdivision but competing properties to be located in a much larger market area. This is especially true in high-end markets, rural markets, and properties with unusual designs, large sites or unusual locations. It would be possible to define a neighborhood as a one mile square and have it include many different land uses, but a market to be a ten square mile area but to only include the competing properties. This does not mean the appraiser can expand the market to include lesser comparable properties when better comparables exist.

In any analysis that draws conclusions about a market's over or under supply, price increases or declines and level of demand, the appraiser must compare like properties and in many cases, the analysis must include enough data to make it meaningful. Comparables should come from the same market as the subject and preferably from the same neighborhood. Sales or listings that reflect a significantly different market should not be used as comparables.

Sufficient Data to Adequately Analyze the Market – Appraisers should refrain from relying on an analysis unless there is sufficient data to ensure that one or two data points (comparables) with incorrect information or an unknown factor would not affect it inordinately.

The lack of adequate numbers of sales is also a problem with regression models and even in the commonly used Fannie Mae 1004MC (market conditions) form. When using statistics to support an opinion of market conditions, an appraiser should strive to get a sufficient number to ensure no single sale has too much of an impact on the analysis. For many appraisers, finding three sales and three listings is a problem, and finding 30 of each is impossible. In those cases, the appraiser should not put much credibility in that statistical measure. Direct analysis of a few well-verified sales can be done with limited data but using minimal unverified data with statistical analysis should be avoided.

V. Verification of Data

Some clients are reporting that appraisers are using data that is not verifiable in small sample direct comparison analyses. Appraisers should avoid using data obtained from sources that have an interest in the outcome of the appraisal. There have been many examples of appraisers using sales data obtained from the builder of the subject without verification. There are also cases of some brokers, builders or experienced sellers reporting inflated sale prices or incorrect physical data about the sale property to ensure they do not have appraisal problems in the future. The use of erroneous data has led to value opinions that are not credible and, therefore, losses to the client. For example:

> A local builder built 30 houses in a subdivision. The first five sales of homes included well-finished basement levels. The builder reported the correct sale price but showed the sales as not including a basement. This misleads appraisers to a false value opinion for many properties in that market.

Data verification is also necessary in some markets to determine if the comparables and/or market data are reflective of the highest and best use. It is an error to use comparable sales that reflect one buyer's intended use to develop an opinion of value with a different highest and best use. For example, a property sold with a house on a site which was immediately razed, but the appraiser uses this sale as an improved property comparable. The buyer was not purchasing an improved property, but a vacant site.

The Most Probable Buyer Type – It is a basic step in any market value appraisal for an appraiser to identify the most likely buyer type. This is true for single-unit housing, office buildings, industrial buildings and agricultural land. It is not possible to develop an opinion of market value unless an appraiser is able to determine who the likely buyer type is and their criteria for purchase. It is important for the appraiser to know who the most likely buyer type is and what motivates their decision to buy. If the subject is only salable to an investor, then the best comparables would be properties that sold to investors, not to owner-occupants.

The Intended Use – USPAP requires appraisers to know the intended use of the appraisal report. In some markets where investor and owner-occupied markets exist in the same geography, it is important for appraisers to identify the defined value and in many cases, substituting a different value definition (based on communication with the client) may be appropriate (e.g., disposition value, liquidation value, etc.) if needed. Clients that regularly order appraisals should also be aware of these various defined values and should instruct the appraiser according to their needs.

It is especially difficult to develop a reliable opinion of market value using only minimal data without verification. Verification of market data is important and is a function of the scope of work. In the case of market value appraisals in declining markets this part of the appraisal process is important because of the varied criteria for purchase in markets with both owner-users and investor-entrepreneurs. If an appraiser is developing a market value opinion based on the most likely buyer type, the appraiser needs to know if the buyer of a comparable was an owner-user or an investor-speculator. This determination is necessary to match up the sales with the most probable buyer. This is again referring to the public perception of the term "Market Value."

Foreclosure Related Sales – It is common in many markets to find that the sales of bank-owned properties have sale prices that are significantly lower than properties of similar size, condition, age, etc. Many appraisers report that REO sales sell for 5-25% less than non-REO sales in the same market and with the same property condition. It may not seem logical but it is the reality of the situation.

The discounted prices found in the sales of REO properties have perplexed many appraisers. This leads to the question, "What is the correct value to convey within the definition of 'market value' if the appraiser finds sales that were discounted because of the REO status and other sales in the same market that were not distressed?" Should an appraiser convey the value based on discounted REO sales or based on non-discounted sales to owner-occupants, or someplace between the two?

Markets with mostly investor sales – In some price ranges within a market there have been overwhelming numbers of foreclosure properties for sale at the same time as non-distressed properties. This substantial increase in supply with very motivated sellers has caused prices to be significantly lower. In these markets, there are few non-investor sales to choose from, so appraisers have no choice but to use investor sales as comparables. Therefore, the value they are reporting is clearly reflective of the investor buyer since that is the majority of the buyers in that market. In this case, market value is based on investor's actions since they are the most likely buyers. The client needs to be told that the value opinion developed is reflective of this "investor market." Appraisers need to disclose this issue so the client will not be surprised to find that the property may sell again a year later for much more than the price paid by the speculator. Potential for resale of the property at a higher price at a later date is what many speculators require to purchase.

Markets with Mostly Non-investor sales – In these markets, there are very few if any investor properties for sale which means the appraisers have no choice; they must use owner-user (non-investor) sales since that is all they have. These markets are functioning like most markets did prior to 2006. Most appraisers, clients and investors have no problem recognizing and using these value opinions as a basis for decision making. It is logical to use these non-investor sales as a reflection of market value in these markets where there are few investor sales and most sellers do not have to compete with the investor sales in the market.

Markets with both investor and Non-investor sales – The most significant problem for appraisers is in markets where both REO and non-REO sales are found and where there is a significant difference in the sale prices between these two classes of properties. This situation has led many appraisers to question if they should adjust the investor sales up to the owner-user level or adjust the owner-user sales down to the investor-entrepreneur level? This is asking which class of sales is most appropriate. In estimating market value, appraisers are required to determine who is the most likely buyer for the subject and it is logical that they use comparable sales that reflect that opinion. If the subject must compete in the investor market, the comparables should come from that market. If the most likely buyer for the subject is an owner-occupant retail buyer, then the comparables should be from that market. The appraiser can make a judgment about the likely nature of the most probable buyer and the value that would probably result, but would likely report the presence of the other type of buyer and that resulting price. For example:

> The subject of an appraisal is a property that was recently foreclosed by a local bank and is now for sale. The prior owners lived in the house for 18 months after they defaulted and did

not maintain the property. It now needs $40,000 in repairs. The appraiser thinks the subject would sell for $400,000 if repaired but the assignment is for an “as-is” appraisal. The appraiser determined the most likely buyer is an investor and that an owner-user would not buy this because of the difficulty in getting financing, the time it would take to repair the property and the difficulty in dealing with real estate agents that focus on REO properties.

The appraiser judged that the most likely buyer was an investor who required a profit. She used comparable sales that were also REO properties. The market value based on sales where the buyers were investors was $325,000. The possibility of a higher price with the repair cost could be reported based on the data.

In some markets, the use of REO-investor sales is not an issue since the state may have given appraisers guidance on the issue. This is not common in market value appraisals but may be found in some state’s assessment rules. If that is the case, to eliminate any confusion, appraisers must disclose they are following a state law or regulation and define that value per the state law.

Identification of Appropriate Sales and Listings – All appraisal assignments require an appraiser to develop an opinion of value and usually report it to the client. This requires a discussion or at least an understanding with the client of the intended use of the assignment results. The intended use will help an appraiser understand the goals of the client, the level of analysis and the format needed for the report.

There can be significant differences in prices between properties at the investor and the owner-occupied level in markets where both types of properties are offered for sale. The common question presented by appraisers, lenders and especially assessors is, “Which comparable sales are appropriate in providing an opinion of ‘market Value?”

When considering this issue, the public perception of the defined term, the client’s intended use of the appraisal report and the public policy should be considered. It is apparent that an appraiser should tell the client what the current economic conditions are and if they have developed a value at the investor-entrepreneur price or the owner-user price.

If an appraiser finds the subject property is located in a market where both non-REO and REO property sales exist and these result in significantly different value opinions, the appraiser should use the comparable sales that represent the actions of buyers most similar to the most probable buyer for the subject. It is also possible for an appraiser to give clients two values, properly defined, in the same report.

Absent law to the contrary, if the appraiser is requested to use “only REO sales” or not use REO sales, the appraiser must decide if that request allows the appraiser to produce credible assignment results based on type and definition of value in the report. If a conflict arises, the appraiser must decline or withdraw from the assignment or, if the client agrees, utilize a type and definition of value that meets the client’s expectations and accurately describes the market in which the subject will compete. It would be misleading in a market value appraisal to use non-REO sales as comparables for a property that will compete in the REO market, or not adjust them to reflect the most likely buyer. It is a violation of USPAP to mislead the reader of the report. The value opinion should be consistent with the defined value and the most likely buyer for market value appraisals.

Transfers that are NOT indications of market value – There are transfers of real property that are not indications of market value. A sale from related parties is seldom a good comparable nor is a sale where the purchaser has contracted to have a new home constructed. These sales usually do not reflect any existing obsolescence. These are especially troublesome in declining markets where the contracts do not reflect the external obsolescence. There is some guidance on this issue on the certification pages of the commonly-used secondary market appraisal forms. In most states, foreclosure sales (at the courthouse) are not comparable sales for most properties.

VI. Support for Adjustments

Some appraisers have a difficult time supporting adjustments in residential appraisals and in some cases making adjustments for conditions of sale. The residential forms do not have a line for conditions of sale so many appraisers are not sure they can make such an adjustment. This adjustment is used to compensate for difference in buyer or seller motivations. Although this is a standard line in most non-residential sales comparisons, it may be new to residential appraisers. An appraiser can make an adjustment to a comparable sale to compensate for the level of trade. The adjustment should reflect the market difference between the sale price of the comparable and the assumed conditions of sale within the appraisal.

There are five generally-accepted techniques for extraction, reconciliation and application of adjustments in the sales comparison analysis. They are:

1. Paired-Sales Extraction (a.k.a. sales comparison analysis)
2. Depreciated Cost
3. Income Capitalization
4. Buyer interviews
5. Statistically Supported Models, such as linear and multiple regression analysis

Paired-Sales Extraction of Adjustments (a.k.a. Sales Comparison Analysis) – Assuming adequate data, this is the preferred method of extracting and supporting adjustments because this technique is closest to the market activity. The sales comparison analysis is a direct study of buyer behavior.

This technique requires the appraiser to find sold or leased properties with and without a feature and then isolate the price or rents difference by comparing total property prices or rents. In this case, the appraiser would try to find comparable sales that sold as REO properties and nearly identical sales that did not sell that way to extract the dollar or percent difference due to the stigma or motivations.

A common application of this is in the estimation of the rate of increase or decrease in prices in a market. It is common for appraisers to estimate the rate of loss in value by comparing a sale of a property five years ago with the sale price now. If the change in price is due to market changes alone then that rate of change can be attributed to the market conditions. Since there are many factors that will affect this, most appraisers try to have several pairs of sales and resales to work with. For example, listed in the chart below are four sales of properties that have recently sold and resold.

When reviewing the sales below, remember if these properties are improved, they are not identical when sold the first time vs. the second. The buildings are at least a little older each resale. It is quite possible for a market to fall 10% each year for two years, level off for two years and then fall by 5% each year for two more years. This means if a sale and resale were measured, the overall amount of change in the market would be an aggregate of the various rates of change.

	Comparable 1	Comparable 2	Comparable 3	Comparable 4
Initial sale date	3/15/08	5/5/06	7/16/06	5/5/07
Initial sale price	$ 455,000	$ 605,800	$ 535,600	$ 499,000
Second sale date	10/1/11	9/15/11	7/19/11	8/15/11
Second sale price	$ 425,600	$ 555,000	$ 495,000	$ 460,850
Overall % of change	-6.46%	-8.39%	-7.58%	-7.65%
Years between sales	3.5455	5.3634	5.0075	4.2793
% change per year	-1.82%	-1.56%	-1.51%	-1.79%

This is a simple example to show the paired-sales method. The above rates of change are based on straight-line change. Compounded rates of change can be calculated with calculator support. The "before" and "after" prices could reflect some other difference as well.

Depreciated Cost – This technique is based on the premise that buyers use cost of construction as a basis for adding or subtracting value for a feature. For example, a typical buyer might think they really want a porch but the house they like the most does not have one so they consider buying the house and adding the porch. This would be an example of a buyer using cost as a basis for adjustment in price.

Income Capitalization – It is also possible to extract and support adjustments in the sales comparison approach by extracting them from the rental income attributable to the feature and then capitalizing that income difference via an appropriate technique. This assumes an appraiser can isolate the difference in market rent attributable to a property characteristic and that amount can be capitalized (converted to a lump sum). This type of analysis is useful when there are features included with the subject property such as apartment units, barns, or extra acreage that the rental rate is discernible.

Since this is a ratio analysis, it is important to remember that some items will affect both rental rate and sale price but some things only affect the sale price. Items that affect only the price are difficult to isolate this way (e.g., a needed roof covering).

Buyer interviews – The last method for supporting adjustments is researching buyer's attitudes by doing buyer interviews to ask buyers how much of the price they attribute to an item. This can be more subjective than analytical but it also may reveal the diversity of opinions in the market over the value of a feature.

This assumes:

1. Buyers are truthful;
2. Buyers know what they want;
3. Buyers will answer questions; and
4. The appraiser knows the right questions to ask.

VII. Integration of the Opinion of Market Trends into the Appraisal Analysis

Many clients and appraisers ask about the correct procedure for compensating for over or under supplied markets in an appraisal analysis. If the market values are increasing or decreasing, what should an appraiser do with this information?

Obsolescence in the Approaches to Value – There are many situations where appraisers have to consider losses in value due to factors other than normal physical depreciation. These include losses for functional problems and external factors. In the case of declining markets, the obvious diminution in value is caused by external obsolescence.

External obsolescence is the loss in value due to factors outside the property. This loss in value is commonly attributable to less demand causing falling prices at a rate beyond what lower construction costs would accommodate. The lack of new construction in a market is an obvious indication of the possibility of external obsolescence since prices lower than cost usually eliminates most new construction. Of course, some buyers will purchase new homes regardless of the price of existing homes.

If it exists, external obsolescence must be reflected in all three approaches to value. These would include locational or economic issues, or both. An example of a locational issue would be a railroad track next to the residence. An example of an economic issue would be an oversupply of sellers and undersupply of buyers.

It is not unusual for a client or even an appraiser to think that, in a declining market with external obsolescence, an adjustment to the sales comparison analysis is needed. In most cases, the sales used already reflect the loss and an adjustment for this issue would essentially be deducting for the same thing twice. It is quite appropriate to use negative market conditions adjustments in markets where values are falling during the time between the sale and the effective date of value. If the market has been declining but has stabilized, no market conditions adjustment may be needed.

VIII. Using Statistical Tools in the Development of Appraisal Analysis

Only 35 years ago, most real estate property sales and physical information was only listed on paper. The MLS systems were facilitated by making many copies of the listing pages and distributing them to various brokerage offices. County records were all on paper and unavailable anywhere else. With each passing year, more and more data is placed in computer files and therefore easily obtained by owners, lenders and appraisers.

The appraisal profession has changed dramatically in the last 35 years. Most appraisers agree that changes in the future are inevitable and it may not be too long before local appraisers develop their own AVMs or some variation on that theme (e.g., AVMs with human inspections of the subject). Whatever the future brings, it will more likely be based on electronic analysis than on paper. The following is a discussion of utilization of AVMs and Computer Assisted Mass Appraisal techniques which are being used by some appraisal firms today and possibly individual appraisers in the not too distant future.

This section discusses the growing availability of statistical tools of potential use to appraisers, especially in declining markets. This topic differs from the discussion in Section II in the following way: Section II discusses databases used to generate house price indices and the various statistical approaches used to estimate these indices. This section offers a brief discussion of a wider variety of statistical tools and approaches used to appraise individual properties.

A classic term for such an approach is CAMA (Computer Assisted Mass Appraisal). Another term is AVM (Automated Valuation Model). Statistical valuations of this type are produced by a wide variety of public and private vendors. Such valuations rely upon a wide variety of statistical tools and user judgments to assign values to individual properties. These methods have become much more available to much wider audiences in recent years owing to the enormous increase in the amount and quality of available data.

During normal market conditions these tools have the potential to provide a credible and low-cost alternative to an appraisal by a certified appraiser when ample data are available, appropriate statistical techniques are employed, and when the physical conditions of the properties are not in question. These models and the valuation estimates they produce can also be ranked in terms of their precision; a common term in this industry to describe AVM precision is its “confidence score.” As such, AVMs offer the opportunity to target appraisals upon those properties in which AVM confidence scores are low.

AVM/CAMA models have both strengths and weaknesses relative to traditional appraisal models in declining markets. The point of this section is to discuss some of the advantages and disadvantages of AVM/CAMA models in declining markets and offer some suggestions. The section does not offer a primer on the statistical techniques underlying AVMs/CAMAs since this is better left for instruction at a college or professional society course.

Possible Advantages of AVM/CAMA Models in Declining Markets

Three potential advantages of AVM/CAMA relative to traditional appraisal practices models are discussed.

1. They offer the potential to compensate for reduced numbers of sales in declining markets. Declining markets typically involve fewer numbers of regular or non-distressed sales with which to generate a set of comparable sales. A statistical approach to valuation offers the potential to expand the number of comparable sales by expanding the traits of the properties involved and their locations. For example, a statistical approach such as regression analysis may consider properties with different numbers of rooms, bedrooms, and square footage and include controls for these traits in the regression model.
2. The models can incorporate and quantify the impact of nearby distressed sales in declining markets. The volume of distressed properties in many markets today is unprecedented. Traditional rules of thumb regarding the gap between the price of a regular sale and an otherwise comparable distressed property sale are being challenged. Most importantly, evidence is mounting regarding the impact of distressed properties upon the sale prices of non-distressed properties in the same market. Statistical models have the potential to measure these disparities in a systematic way by including various controls for different types of distressed sales and even the number of properties in the pre-foreclosure process.

3. Sensitivity analysis is facilitated. A statistical approach combined with modern information technology offers the potential to do a much wider variety of sensitivity analysis in less time than traditional appraisal methods. This can also serve to highlight critical assumptions underlying an appraiser's ultimate judgment.

Possible Advantages of Traditional Appraisal Practices in Declining Markets

Traditional appraisal practices offer at least three major advantages relative to AVM/CAMA models.

1. Appraisers draw on a deeper knowledge of local market conditions and boundaries than are readily incorporated into statistical models. For example, appraisers are typically more aware of critical neighborhood boundaries associated with different school districts, traffic patterns, and other hard to quantify neighborhood traits than are typically incorporated into AVM/CAMA models.

2. Appraisers can use a definition of distressed properties that best fits the local market. State and local laws, customary practices, and regulations are important factors in determining the size and composition of the distressed inventory. For example, some states have a *de facto* moratorium on new foreclosures, and the days to completion of the foreclosure process can vary widely among states. As such, the best definition of a distressed inventory will benefit greatly from knowledge of local laws, regulations, and practices. The experienced appraiser may have an advantage in this process relative to definitions of distressed properties used by statistical approaches.

3. Most importantly, diminished physical condition is a frequent trait of distressed real estate. Assessing the effects of deferred maintenance or more serious damage is best accomplished by in-person inspections of the properties. Statistical approaches do not readily incorporate such qualitative insights. This is particularly important for decisions about whether to include REO properties as part of a set of relevant comparables.

In conclusion, when appraising during a period of declining markets:

1. It is incumbent upon the appraiser to develop a definition for a declining market, and support a conclusion of that decline in his or her context;

2. A number of sources of data are available to support conclusions of decline;

4. Numerous definitions of value exist besides market value and one or more may better describe the nature of competitive transactions in the relevant marketplace and meet the client's needs;

5. Appraisers should consider the intended use of the appraisal report and then attempt to solve the client's problem. In most cases, when clients ask for "Market Value" they simply want to know what the gross price would be if the property were put on the market on the effective date of appraisal.

6. The market area may be more relevant for the collection and analysis of trend data;

7. Verification is required by USPAP and is needed to understand the motivations of market participants and arrive at a conclusion of the likely buyer type as a subset of the highest and best use conclusion; this, in turn, influences the selection of the value definition which in turn guides the selection of comparable transactions;

7. Adjustments can and should be made, with support, where necessary for conditions of sale in declining markets; and

8. Statistical methods may offer a way to support a variety of adjustments.

Glossary of Terms

- **Bank-owned property (see REO or OREO)**

- **Deed in lieu of foreclosure –** The seller will convey the property to the lender by means of a deed or similar instrument of transfer. The property is typically transferred via warranty deed or a quit claim deed, and the total reported purchase price is the amount of the loan in default and may include associated fees. It then becomes the financial institution's property, without the lender having to incur the costs and time associated with going through the foreclosure process. Because the transaction is not exposed to the open market and the reported consideration is predicated on the amount required to satisfy the debt and not on the market value, it should not be used for sales ratio studies, model calibration, or comparable sales analysis. It should show up during the clerical screening as a transfer to a financial institution; this is not a sale.

  Source: *Executive Summary: A Guide to Foreclosure-Related Sales & Verification Procedures* (IAAO Executive Board, 2009)

- **Disposition value –** The most probable price that a specified interest in real property should bring under the following conditions:
  1. Consummation of a sale within a future exposure time specified by the client.
  2. The property is subjected to market conditions prevailing as of the date of valuation.
  3. Both the buyer and seller are acting prudently and knowledgeably.
  4. The seller is under compulsion to sell.
  5. The buyer is typically motivated.
  6. Both parties are acting in what they consider to be their best interests.
  7. An adequate marketing effort will be made during the exposure time specified by the client.
  8. Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.
  9. The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

  This definition can also be modified to provide for valuation with specified financing terms

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Distress sale –** A sale involving a seller acting under undue duress. See also *disposition value*; *forced sale*; *liquidation value*.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Entrepreneurial incentive** – The amount an entrepreneur expects to receive for his or her contribution to a project. Entrepreneurial incentive may be distinguished from entrepreneurial profit (often called developer's profit) in that it is the expectation of future profit as opposed to the profit actually earned on a development or improvement.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

- **Forced-sale price –** The price paid in a forced sale or purchase, i.e., a sale in which a reasonable time was not allowed to find a purchaser or the purchaser was forced to buy. See also disposition value; distress sale; liquidation value.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Foreclosure auction / auction sale (financial institution or bank auction sales)**

  1. Auctions at which foreclosure homes from a variety of sources are sold to the highest bidder. Most are conducted at the county level, although the federal/state government also holds them.

     Source: *Foreclosure Deals*, *www.foreclosuredeals.com/foreclosure-auctions/*

  2. Bank auction sales are used by financial institutions to liquidate excess OREO properties. They contain multiple properties that are offered for sale as auction lots at the same time but not necessarily geographically together. These auctions may have from one to dozens of properties available. The terms could be an absolute auction or a reserved bid.

  Source: *Executive Summary: A Guide to Foreclosure-Related Sales & Verification Procedures* (IAAO Executive Board, 2009)

- **Foreclosure sale**

  1. The actual forced sale of real property at a public auction (often on the court house steps following public notice posted at the court house and published in a local newspaper) after foreclosure on that property as security under a mortgage or deed of trust for a loan that is substantially delinquent. (See foreclosure for a description of that process) The lender who has not been paid may bid for the property, using his/her/its own unpaid note toward payment, which can result in a bargain purchase.

     Source: *Legal-Dictionary*, http://legal-dictionary.thefreedictionary.com/foreclosure+sale

  2. Foreclosure sale is the closing of a liability, obligation, receivables etc., by recovering the dues by selling the property in his possession, before waiting the action or fulfillment from the debtor.

     Source: *Legal Explanations*, http://www.legal-explanations.com/definitions/foreclosure.htm

  3. The actual sale of real property at the conclusion of a foreclosure proceeding. The sale may be to a third party as a result of a high bid, or to the foreclosing creditor if there are no bids higher than the amount of the defaulted debt plus foreclosure costs.

If the sale generates proceeds beyond the satisfaction of the debt and foreclosure costs, the balance generally must be refunded to the party who has lost title to the property.

Source: Lists Plus – Folio 101, http://www.folio101.com/listsplus/foreclosure.asp

4. A sale of mortgaged property to obtain satisfaction of the mortgage out of the proceeds, whether authorized by decree of the court or by a power of sale contained in the mortgage.

   Source: *Black's Law Dictionary*, Sixth Edition West Publishing Co., 1990

5. Sale of property to satisfy a debt.

   Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Judicial foreclosures –** Judicial foreclosures are processed through the courts, beginning with the lender filing a complaint and recording a notice of Lis Pendens. The complaint will state what the debt is, and why the default should allow the lender to foreclose and take the property given as security for the loan. The homeowner will be served notice of the complaint, either by mailing, direct service, or publication of the notice, and will have the opportunity to be heard before the court. If the court finds the debt valid, and in default, it will issue a judgment for the total amount owed, including the cost of the foreclosure process. After the judgment has been entered, a writ will be issued by the court authorizing a sheriff's sale. The sheriff's sale is an auction, open to anyone, and is held in a public place, which can range from in front of the courthouse steps, to in front of the property being auctioned.

  Source: *All-Foreclosure.com*, www.all-foreclosure.com/help/judicial.html

- **Lis Pendens** – Filed by a lender, lis pendens is a formal notice that starts the foreclosure process. Even though this is considered a pending lawsuit, the homeowner still has possession and the right to sell or refinance the property.

  In states that require judicial foreclosure actions, lenders traditionally file a lis pendens to foreclose on a mortgage or deed-of-trust loan that is in default. On the other hand, a notice of default is used in states that follow non-judicial foreclosure laws.

  Source: *www.foreclosure.com*, www.foreclosure.com/lispendens.html

- **Liquidation value**

  The most probable price that a specified interest in real property should bring under the following conditions:

  1. Consummation of a sale within a short time period.
  2. The property is subjected to market conditions prevailing as of the date of valuation.
  3. Both the buyer and seller are acting prudently and knowledgeably.
  4. The seller is under extreme compulsion to sell.
  5. The buyer is typically motivated.
  6. Both parties are acting in what they consider to be their best interests.

7. A normal marketing effort is not possible due to the brief exposure time.
8. Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.
9. The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

This definition can also be modified to provide for valuation with specified financing terms. See also *disposition value*; *distress sale*; *forced-sale price*.

Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Market –** (1) A set of arrangements in which buyers and sellers are brought together through the price mechanism; the aggregate of possible buyers and sellers and the transactions between them. (2) A gathering of people for the buying and selling of things; by extension, the people gathered for this purpose.

Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Market Area –** The area associated with a subject property that contains its direct competition.

Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

- **Market segmentation –** The process by which submarkets within a larger market are identified and analyzed.

Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010).

- **Market value**

The major focus of most real property appraisal assignments. Both economic and legal definitions of market value have been developed and refined. The most widely accepted components of market value are incorporated in the following definition:

The most probable price that the specified property interest should sell for in a competitive market after a reasonable exposure time, as of a specified date, in cash, or in terms equivalent to cash, under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, for self-interest, and assuming that neither is under duress.

1. The following definition of market value is used by agencies that regulate federally insured financial institutions in the United States:

The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- Buyer and seller are typically motivated;
- Both parties are well informed or well advised, and acting in what they consider their best interests;
- A reasonable time is allowed for exposure in the open market;
- Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Source: 12 C.F.R. Part 34.42(g); 55 Federal Register 34696, August 24, 1990, as amended at 57 Federal Register 12202, April 9, 1992; 59 Federal Register 29499, June 7, 1994

2. The International Valuation Standards Council defines market value for the purpose of international standards as follows:

   The estimated amount for which an asset should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently, and without compulsion.

Source: International Valuation Standards (IVS), (International Valuation Standards Council (IVSC)) London, 2011

3. Uniform Standards for Federal Land Acquisitions defines market value as:

   Market value is the amount in cash, or on terms reasonably equivalent to cash, for which in all probability the property would have sold on the effective date of the appraisal, after a reasonable exposure time on the open competitive market, from a willing and reasonably knowledgeable seller to a willing and reasonably knowledgeable buyer, with neither acting under any compulsion to buy or sell, giving due consideration to all available economic uses of the property at the time of the appraisal.

Source: *Uniform Appraisal Standards for Federal Land Acquisitions* [Paperback] Interagency Land Acquisition Conference 2000 (Author), December 2000, published by the Appraisal Institute, Chicago, in cooperation with the U. S. Department of Justice; page 13; also at http://www.justice.gov/enrd/ENRD_Assets/Uniform-Appraisal-Standards.pdf as of October 28, 2011.

4. Freddie Mac and Fannie Mae

   Market Value – The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

(1) buyer and seller are typically motivated;

(2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest;

(3) a reasonable time is allowed for exposure in the open market;

(4) payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and

(5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

Source: Freddie Mac Form 79 and Fannie Mae Form 1004, March 2005

- **Neighborhood** – (1) A group of complementary land uses; a congruous grouping of inhabitants, buildings, or business enterprises.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

- **Non-judicial foreclosure –** Non-judicial foreclosures are processed without court intervention, with the requirements for the foreclosure established by state statutes. When a loan default occurs, the homeowner will be mailed a default letter, and in many states, a Notice of Default will be recorded at approximately the same time. If the homeowner does not cure the default, a Notice of Sale will be mailed to the homeowner, posted in public places, recorded at the county recorder's office, and published in area legal publications. After the legally required time period has expired, a public auction will be held, with the highest bidder becoming the owner of the property, subject to their receipt and recordation of the deed.

  Source: *All-Foreclosure.com*, www.all-foreclosure.com/help/judicial.htm

- **Notice of trustee's sale –** A formal notice that sets the date, time, and place of a property that is being sold. This document is recorded with the county recorder and, in some non-judicial states, is the only document in the foreclosure process.

  Source: DefaultResearch.com, May 26, 2011, www.defaultresearch.com/glossary/noticeoftrustee

- **OREO –** A term used primarily by commercial banks to identify real estate on the books that was taken back through foreclosure of a mortgage loan. The term other real estate owned is used by banks to distinguish foreclosed real estate from bank real estate owned (REO), which is corporate real estate assets. Typically the real estate industry uses the term REO for foreclosed real estate.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

- **Pre-foreclosure sales (sales to limit losses) –** Pre-foreclosure sales to limit losses occur prior to the Sherriff's Sale or Administrative Sale. They can be difficult to detect since the financial institution is not listed as party to the transfer. They must be researched to ensure they meet the market value test. Because the financial institution is a silent partner, the amount of stimulus the seller experiences must be very carefully examined during the validation process. See also Short Sale.

  Source: *Executive Summary: A Guide to Foreclosure-Related Sales & Verification Procedures* (IAAO Executive Board, 2009)

- **Real estate owned (REO) –** In common usage, real estate that has been acquired by a lending institution through foreclosure or mortgage loans, i.e., what is more correctly called other real estate owned (OREO). In best usage the terms owned real estate (ORE) and real estate owned (REO) describe bank premises used for banking operations, and the term other real estate owned (OREO) describes foreclosed real estate held for liquidation.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

- **Redemption –** The process of canceling a defeasible (revocable) title to property, such as one created by a mortgage foreclosure or tax sale. The terms equity of redemption and equitable right of redemption refer to the right of a mortgagor in default to recover title by paying off the entire mortgage prior to the foreclosure sale. After the property has been sold, the mortgagor has no right to redemption unless a statutory redemption period applies according to state law.

  Source: *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010)

  NOTE: State-by-State Foreclosure Rules (see attachment) can be found at Mortgage-Investments.com, May 26, 2011 (www.mortgage-investments.com/originate_private_mortgage_or_deed_of_trust/foreclosure-laws.htm)

- **Sheriff's sale or Administrative sale –** In a sheriff's sale or administrative sale, the property is sold by means of a public auction to the highest bidder. This is done to satisfy either a court order or administrative action. The opening and often the minimum bid amount is set by the amount of the judgment. In many if not most cases, the highest bidder is the financial institution and the bid amount is the sum of the defaulted loan, plus interest and associated fees resulting from a judgment in favor of the financial institution. Even in jurisdictions with a disclosure requirement, no sales instrument may be recorded.

  Because the financial institution bids up to the amount of the note plus fees and interest, the sale price could be more or less than current market value. If the property is acquired by a third party, the sale price may be considered valid if the sale is well advertised and well attended and there is a minimum opening bid below which the seller has a right of refusal. The sale verification process must determine whether the pool of buyers (bidders) was sufficient to deem an open market. If validated, the sale can be used as part of future revaluation cycles, in the calibration of models, and in comparable sales analysis. Other examples of properties for which the auction could attract market value bidders are projects under construction at the time of foreclosure, property with documented redevelopment potential, and unique or historical property.

Source: *Executive Summary: A Guide to Foreclosure-Related Sales & Verification Procedures* (IAAO Executive Board, 2009)

- **Short sale (real estate)**

    1. **Short sale –** A lender approved sale in which the proceeds are not sufficient to cover the mortgage amount(s). Typically done to avoid foreclosure and its inherent costs.

       Source: *Foreclosure and Short Sale Dilemmas and Solutions* (Hondros Learning, 2009)

    2. **Short sale –** A short sale is usually a pre-foreclosure sale in which the total sale price is less than the total amount owed against the real estate. The financial institution agrees to forgive a portion of the loan balance and allows a transfer of title to avoid a formal foreclosure. With the permission of the financial institution, the seller finds a third-party buyer and the proceeds of the sale go directly to the financial institution. In some cases the sale may meet the test for a market value transaction even though the purchase price is less than the outstanding mortgages but not necessarily less than the market value.

       Source: *Executive Summary: A Guide to Foreclosure-Related Sales & Verification Procedures* (IAAO Executive Board, 2009)

- **Trustee's sale –** A foreclosure in a state that uses deeds of trust as a vehicle for granting rights in real property to be used as collateral for a loan.

Source: *The Complete Real Estate Encyclopedia by Denise L. Evans, JD & O. William Evans, JD* (The McGraw-Hill Companies, Inc., 2007)

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