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Foreclosures Haunt Appraisals

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For home builders, **foreclosures** and distressed sales remain a problem even after the houses are sold, hanging over other sales like ghosts.

Sales of distressed properties become comparable sales to gauge value, reflecting decreased market values and forcing builders to shave prices or risk losing a deal. It is yet another problem -- and one expected to last for some time -- for the ailing sector searching for stability as the worst downturn in decades drags on.

For months, builders have complained that **foreclosures** and short sales -- in which a borrower unloads a house for less than what is owed -- pose stiff competition because such houses can sell for steep discounts. Builders even find themselves competing with nearly new houses that they built, which is pushing several of them, including KB Home, to alter their designs.

Once a property is sold, it may be used by appraisers to determine value. Most lenders now require that **appraisals** be based on sales closed within three months, instead of six to nine months, says Bill Garber, director of government and external relations with the Appraisal Institute.

With distressed-deal counts increasing, the comparative sales pool is more likely to include a foreclosure, especially in boom-to-bust markets like Las Vegas, Phoenix and California's Inland Empire.

Back in the housing heyday, when housing values were increasing, low **appraisals** weren't much of an issue. But now, builders grumble that appraisers are being conservative, or even, they fear, discounting values to play it safe.

"The lenders that are using these **appraisals** [for] the amount they will loan, they were just burned by appraisers being too optimistic and liberal in the boom times, so they're going in the opposite direction," says David Ledford, senior vice president at the National Association of Home Builders. "It sort of contributes to a downward spiral in values."

Mr. Garber, of Appraisal Institute, counters that appraisers, who are certified, "don't make the market, they simply point out what is transpiring."

Even so, both sides agree that a main issue is that falling prices -- dragged down by foreclosure sales -- reflect battered markets. The latest S&P/Case-Shiller Home Price Index, which covers all nine U.S. census divisions, recorded a 19.1% decline in the first quarter compared with a year earlier. Since the peak, some markets have seen double-digit price erosion.

Builders also complain that the comparisons don't take into account the added value of a new home. **Foreclosures** can be in bad shape -- missing pipes and appliances -- and require a monetary investment and significant work to be livable.

"They are distressed sales," says Robert Curran, a home-building analyst with Fitch Ratings. "It's not reflective of the true cost of the house."

Mr. Garber says the appraiser simply asks what the property would sell for tomorrow in its current condition. When possible, sales within an existing neighborhood are used first. Adjustments downward are made for sales concessions such as cash for upgrades. There are items, such as pools, that may not be worth as much as they cost to put in.

That has turned the appraisal process into a nail biter for buyers and sellers. If the **appraisals** come in

below the contract price, lenders may not make up the difference, which can amount to tens of thousands of dollars in some cases. Buyers can either come up with more money or ask the builder to reduce the price. **Appraisals** can be appealed or reordered. If that fails, the deal may unravel.

Some builders are forced to search for different comparative sales that they consider a better match. "The best thing they can do is find the best comps, and that just takes more work on their part," says Eric Elder, a spokesman for Ryland Group, the nation's eighth-largest builder by annual closings.

Things only got tougher last month with the advent of the Home Valuation Code of Conduct applying to mortgages that will be owned or guaranteed by government-backed mortgage companies Fannie Mae and Freddie Mac, which have recently accounted for the bulk of new-home loans.

The code prohibits the selection and compensation of an appraiser by loan officers, mortgage brokers or real-estate agents. That has increased the outsourcing of the selection to third-party management companies, which may take some of the fee. Appraisers worry that lenders are ignoring qualifications and hiring solely on cost, and there is concern that out-of-towners unfamiliar with the market aren't "geographically competent" to prepare a thorough appraisal.

"You risk having people unfamiliar with the marketplace having to determine value," Mr. Elder says. "It makes their job harder, and then it makes the entire process more difficult."

The issue is expected to dog the building sector for some time. RealtyTrac recently released its May foreclosure report, which said the number of filings climbed nearly 18% from May 2008. It was the third month in a row that the total number of properties slapped with filings topped 300,000.

Because the government is working to prevent homeowners from losing their homes, it's hard to predict the ultimate number of **foreclosures**. But Barclays Capital estimates new **foreclosures** started this year at 2.8 million, with three million expected in 2010.

Meanwhile, as interest rates climb and unemployment numbers remain high, more owners could be forced into short sales or other desperate moves, prolonging the sector's pain.

"Everything's driving values in one direction," National Association of Home Builders' Mr. Ledford says. "There's no counteracting force."

Ruth Simon and James R. Hagerty contributed to this article.

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