Liability Landmines– Appraisers Beware

By John Lifflander, ASA

Editor's Note: *In this installment of* Valuation Issues and Answers, *John Lifflander, ASA, discusses how to avoid problems in the new world of bailouts, tax credits and, as he points out, business as usual.*

The current economic crisis was largely precipitated by loose credit and loose lending standards. Part of the loose standards involved buying properties with no money down. Last year, it was reported that over 40 percent of recent buyers had purchased their homes without paying one cent. In fact, with concessions given to buyers, many actually *received* money out of escrow, so they were effectively paid to buy a house!

The Federal Reserve kept interest rates at historic lows, which effectively increased prices. The reason is that when shopping for a house, most people look at the monthly payment and not the total price. Consequently, values typically increase when rates decrease. There are, of course, a myriad of other reasons for our current debacle but these are a few of them.

Understanding this, one might think a solution would be to stop the bad practices that caused the problems. However, that is not what is happening. Instead, interest rates are now lower than they have been in over 50 years, with the Fed's Prime Rate at zero percent. Moreover, an incentive has been offered by the government and an $8,000 tax credit for new homebuyers. The Veterans Administration and the United States Department of Agriculture are still offering no-money-down loans and the Federal Housing Authority is still offering loans with a down payment of about three and a half percent.

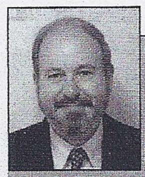
Moreover, real estate agents are writing offers with concessions, which effectively mean that buyers are still purchasing with no money down and often getting money back. This means that some buyers are still being paid to buy homes. Obviously the government hopes to get us out of this crisis with the same bad behavior that got us into it.

$8,000 Tax Credit

What are the ramifications of the current market for appraisers? The $8,000 tax credit is artificially increasing the values of some properties. Our firm is finding that buyers who are getting this credit are often paying more than typical market values. This is why an appraiser may not find comparables that support some sales: this is an artificial bounce to values but it is not a value increase which is inherent in the property. In other words, it cannot be passed on to another buyer and if the property is foreclosed upon, the value of the tax credit will not be realized. For this reason, appraisers should be very careful with new sales which do not line up with the purchase price.

Value of Concessions

Added to this artificial increase in values are two other issues. First, because of the Prime Rate decrease and the money being pumped into banks, courtesy of U.S. taxpayers, interest rates are even lower than they were in 2002



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and 2003 when the market was increasing dramatically. Some fixed rates are four point eight-five percent (4.85%) as compared to six and a half percent (6.5%) only months ago. The difference can be significant in the monthly payment, which generally corresponds to the price a buyer is willing to pay.

Second, concessions continue to inflate values; even the word "concessions" is a misnomer. We often find that either the listing price is increased to cover the concessions or the price is not decreased as much as it would have been without the concessions. This means that the seller is not conceding anything. Rather, the seller is trying to give away something that he or she does not own to begin with—all at the expense of the lender, which ultimately may become the expense of taxpayers.

Unfortunately, concessions are still "business as usual," so comparable sales are often inflated by approximately two to five percent and appraisers are expected to go along with this madness. Our company does not go along with it and unless the value is definitely there, without a question whatsoever, our appraisals do not reflect the "thin air" of concessions. It would be wise, I think, for every lender not to allow contracts that give money to the buyer if they do not want to perpetuate the problems we are currently experiencing. If the price the seller receives is to be lower, let the seller reduce the value accordingly instead of trying to give away something that the seller never had to begin with.

How Much Do I Get If I Buy a House?

We recently had several no-money-down sales with concessions which, when coupled with the $8,000 tax incentive, effectively paid the buyers $15,000 to buy the homes. What happens when interest rates go up and some buyers are laid off and cannot afford the payments? The buyers have no investment in the property, so they are quick to leave, and the result will be more of the same economic problems that are already debilitating our economy.

Appraisers Beware

Appraisers cannot control the bad lending practices which allow buyers to purchase with no money down. However, appraisers need to realize that every appraisal is a lawsuit waiting to happen, particularly if the property is foreclosed upon. Right now, there are companies offering to look at foreclosed properties to see if anything can be recovered from appraisers or their errors and omissions insurance. They review the appraisal to see if there are any flaws that might be grounds for litigation. Consequently, if concessions are part of the contract and the appraiser values the property including them, the appraiser should be certain that the valuation backs up the increment of value that the concessions include. Otherwise, the value of the property should only be the net amount—the actual amount that the buyer is paying. Other issues might be if the appraiser does not use REO or short sales, when they obviously affect the market, or if there are more recent comparables that were not used, which would have brought about a lower value conclusion.

Sale Price as Evidence of Value

The sale price of the property, according to case law in many states, is extremely convincing evidence of the property's value. Therefore, it is legally proper that appraisers consider the "real" purchase price when analyzing a sales contract. There is a mindset among some appraisers that it is their job to make a transaction work but nothing could be further from the truth. Rather, the appraiser has the responsibility to protect the lender and him or herself. Recently, we were accused of being "mean" because we did not "bring in the value." The owner could not understand why we would not allow the sale price. We explained that we are personally liable and may have to pay the difference if our value is inaccurate. Remember, the owner and the lender will not be there to help you if you are sued. If fact, they probably could not care less; they simply want their loan. You may even believe the sale price or refinance request is reasonable but if you cannot unquestionably prove it, do not "stick your neck out." A good test is this: For every appraisal you perform, imagine yourself in court trying to explain why the value is accurate. If you cannot, reduce the value until you can. One lawsuit can drag on for years and may be the end of an appraisal career if a license is revoked or if errors and omissions insurance can no longer be purchased or purchased at a reasonable cost.

U.S. Debt Affects Market Values

As lenders continue with their "madness" it is particularly important that appraisers protect themselves from liability and also become an instrument for stabilizing the real estate market by not continuing the bad practices of the past. Since the United States has increased its debt, which is financed through borrowing from the sale of bonds to other countries, it is quite probable that interest rates, at some point, will have to increase to continue to attract those funds. That increase will affect mortgage rates, which will effectively lower market values (remember people buy based on the payment), which may lead to more foreclosures and more scrutiny of appraisals. Since appraisers are charged with determining the present worth of future value, understanding these economic issues is part of the appraiser's responsibility. WRE