Declining Market Designations and Market Forcast Analysis

by Larry Green

To the surprise of many appraisers in the Portland-Vancouver-Beaverton-Oregon-Washington Metropolitan Statistical Area (MSA), Fannie Mae, Freddie Mac and several major lender guarantors identify this MSA, as a “declining market.” This MSA consists of Multnomah, Washington, Clackamas, Columbia and Yamhill counties in Oregon, as well as Clark and Skamania counties in Washington. The declining market designation applies to several other regions in Oregon, such as Douglas, Jackson, and Deschutes counties. Newspaper headlines such as **“Declining Market Designation Stumps Experts”** have been published in several areas around the nation. More and more appraisers are now being asked or required to report market condition as “Declining,” and they feel pressured by their lender/clients and/or appraisal management company (AMC) clients to comply. Well, let me help to explain the current situation by looking at how Fannie Mae, Freddie Mac, and guarantor mortgage insurance companies gather their data and identify “declining markets.”

First, Fannie Mae and Freddie Mac (Government Sponsored Enterprises – GSEs) rely on data gathered by the Office of Federal Housing Enterprise Oversight (OFHEO), http://www.ofheo.gov. OFHEO publishes quarterly rankings by MSAs based on House Price Index (HPI). The HPI is a broad measure of the movement of single-family house prices on the national, state, and MSA level. The HPI is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales and *refinancings* on the same properties. This information is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages have been purchased or securitized by GSEs since January 1975. With the release of the fourth quarter HPI, OFHEO made modifications to the way its national HPIs are computed. Most important to appraisers is the separation of the sale-resale purchase-only index from the all-transaction index, which included GSEs refinance transactions of the same property. For a greater understanding of OFHEOs methodology, you should spend some time at their website.

Now let’s get back to the “declining” designation. The GSEs identify a declining market when two quarterly statistics decline in the rate of appreciation, not just in a calendar quarter. This method has some good reliability because it provides higher confidence that the data extracted is sufficient to support a valid trend. The point is, a market area may indicate appreciation, but the rate of appreciation is declining when measured by quarter over quarter trends. According to FreddieMac, market declines exceeding one-percent for the most recent two calendar quarters represent a declining market, or when year-over-year statistics indicate overall market declines in the MSA. The exception is when an increase is shown in the two most recent calendar quarters. FannieMae simply states, “a declining market is one in which home prices are currently declining.”

For example, although Portland’s MSA shows a fourth quarter 2007 (4Q07) appreciation of 0.30%, the third quarter (3Q07) appreciation is 0.71%. By applying the GSE’s criteria for measuring market trends by calendar quarter over quarter, the calculation indicates the market declined 57.75%. From 2Q07 to 3Q07, again the change from the prior quarter 2007 declined 54.78%.

On an annual basis, Portland’s MSA shows 2007 appreciation of 4.24% while 2006 annual appreciation was 13.45%. By applying the GSE’s criteria for measuring market trends by calendar year-over-year, the calculation indicates the market declined 68.48%.

Standard & Poor’s/Case-Schiller® monthly home price indices for 20 metropolitan areas includes the Portland MSA. According to S&P’s index, the Portland MSA peaked July 2007 at 186.51 and declined each month to January 2008 to 178.81. The most significant decline is from December 2007 to January 2008 indicating a 2.01% drop.

The frustration with many Portland MSA appraisers is they point to Residential Multiple Listing Service (RMLS) and National Association of Realtor (NAR) http://www.realtor.org/Research.nsf/Pages/MetroPrice data, which indicate appreciation trends. NAR reports the median sales price of an existing single-family home in Portland’s MSA as $290,500 for the fourth quarter 2007. This is up 1.8% above the fourth quarter median sales price of $285,400 in 2006. On an annual basis, the 2007 median sales price of $295,200 is 5.13% above the 2006 median sales price of $280,800. It paints a different picture when you look at the last two quarters of 2007. Third quarter 2007 median sale price of existing homes peaked at $299,700 and fell to $290,500 in the

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fourth quarter, experiencing a 3.07% decline. The median sale prices were not seasonally adjusted. All these web sites are available free to appraisers and should be included in the "appraiser's toolbox" for market trend analysis.

Secondly, the GSEs consider market watch research by several major lender guarantors. To name a few, AIG United Guaranty - https://www.ugcorp.com/decliningmarkets.html,

Genworth Financial Inc. - http://www.gemortgageinsurance.com/, and Republic Mortgage – http://www.rmic.com/Pages/default.aspx. Each of these reports the Portland MSA as a declining market.

Fannie Mae Announcement 07-11 addresses Collateral Valuation Practices and Declining Markets (07/13/07). The announcement advised all lenders of a new message in *Desktop Underwriter® (DU®)*. This message will be generated when it appears that a property is located within a declining market (as defined by the GSEs). In these instances, DU will provide a message back to the submitting lender:

The subject property has been identified as being located in either an area of declining home prices or in an area where it may be difficult to assess home values. The lender should carefully review the appraisal to ensure that the appraiser has appropriately analyzed property value trends and overall market condition to arrive at the value provided. The lender should request additional support from the appraiser if it determines that the appraisal does not accurately reflect current market conditions ***(e.g. the declining property values field is not checked when market conditions suggest otherwise.)*** {Emphasis Added} *Please refer to our Property and Appraisal Guidelines in Part XI of the Selling Guide.*

Since most loan originations are submitted to the secondary mortgage market for securitization, the submissions must meet the GSE's guidelines. The bottom line is if you feel pressure from your lender/clients or AMC clients, it is not from them, but originates with the GSEs!

So when your client asks or requires the "declining" market condition be reported, or the appraisal report will be rejected, here are some suggestions:

- Be sure to develop your opinion of market trends by employing recognized techniques for identifying supply and demand.
- Appraisers may check the declining box based upon the GSE's designation of a declining market.
- Explain the distinction of the GSE's criteria for designation of a declining market, while data exists indicating stable or appreciating trends.

The issue of a declining market designation is closely tied to employing supply and demand analysis. Identifying and measuring the market is undoubtedly one of the most important procedures for all appraisers to have a clear understanding. The appraiser must know the composition of the market. Some elements of comparison could be the taxing district, school system, government services, park district, library district, location – urban, suburban, and rural, fire and police

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Measure 37 and 49 Appraisers Sought

Many of you are aware of the recent passage of Measure 37 (M37) and Measure 49 (M49) which provides compensation to certain property owners for value loss resulting from land use (zoning) changes in the past.

The Board has received a number of phone calls from M37 and M49 claimants asking for referrals for an appraiser capable of completing these assignments. The Board does not refer inquirers to an appraiser or appraisers for a specific assignment.

M37 and M49 appraisals are typically complex appraisals and should only be performed by appraisers with the knowledge and expertise required to perform them competently. M37 and M49 have significant differences in their appraisal requirements, therefore competency in one does not automatically mean competency in another. A number of appraisers do possess competency in one or both of these appraisals assignments types, but it can be very difficult for members of the public to locate them simply by searching our on-line database for certified appraisers.

The Board is considering compiling a list of names of appraisers who believe that they have M39 and M49 competency and making that list available on the Board's website. If you have competency in this assignment type and would like your name added to the list please contact Bob Keith at bob@oregonaclb.org.

Being included on this list does not represent a Board endorsement and the Board will *not* perform any qualification process to determine competency for an appraiser who signs up to be on the list. Competency is the responsibility of the appraiser and misrepresentation of competency by an appraiser would be misleading.

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districts, lot/parcel sizes, utilities available, quality of improvements, and all identifiable physical attributes, such as age, condition, vehicle parking, and accessory amenities. Let's look at the supply and demand tool to calculate the absorption rate.

Here is the methodology to calculate the absorption rate:

1. Identify and evaluate the subject's attributes,
2. Define the typical prospective purchaser profile,
3. Assume the subject property is being presented to the market and design a sales search that will count the number of properties in competition with the subject.
4. Count the number of:
   a) Listings available that compete with the subject's parameters.
   b) The number of comparable sales that have closed in the past twelve months and divide by twelve (12) for the average sales rate per month.
   c) Note if there is an unusually high or low number of pending sale transactions because it could be an indication of a market change.

For example, based on your comparable sale search assume there are 75 sales in the prior twelve months, or 6 sales per month. You also searched available inventory using the same search parameters and found there are 145 competitive properties in current inventory. Dividing the 145 properties by 6, you conclude there is approximately 24 months of available inventory.

To identify and evaluate the subject's attributes the criteria may include all or a combination of the following items, the geographic market area, listing and sale price range, and the subject's basic physical characteristics. The subject's physical characteristics may include the year built, number of stories, basement, number of bedrooms and baths, and garage spaces. Recognize there is some crossover of buyer preferences between the number of bedrooms and baths so don't be too specific. When you do this at least once a month and you have completed this process for several consecutive years, you will be able to know what is a high-buyer traffic and good sales year or a low-buyer traffic and not so good sales year. By the way, the number of properties sold from the available inventory is referred to as "the capture rate." Clearly, supply and demand analysis to calculate market absorption is the easiest and best method to forecast market changes.

However, several other tools are available to analyze market trends. These include Days on Market (DOM), List to Sale Price ratio (%SP:LP), Sale-Resale of the same property, Real Estate Owned (REO) activity, and ratio of new construction to existing home sales. Since this article focuses on declining markets, we will omit discussion of new construction, but it is a useful analysis tool in stable and appreciating markets.

The DOM and %SP:LP tools are appropriate for use when a good reliable accounting of continuous and historic data is available typically from a multiple listing service (MLS) provider. The appraiser in a small market area can also apply this tool as long as they assemble the data regularly and have retrieval capabilities. A sale search is commenced with the MLS system that might begin with the property type (i.e. single family residential, single family residential less than 5 acres, condo/townhome, etc.) and the geographic market area for the number of new listings, average list price, pending sales, closed sales, average sale price, median sale price, %SP:LP, annual DOM, and last 30 days on market. Some of these search parameters will not be available in all MLSs.

What is important here is looking at the relationships over time. Generally speaking, a %SP:LP today of 86% compared to a %SP/LP twelve months ago of 94% would indicate a declining market. When using this tool you should be aware price segmentation within the market can skew the %SP:LP. This happens when either there are an inordinate number of sale transactions that occur on either the upper or lower ends of the price range. Furthermore, some MLSs calculate the %SP:LP from the last adjusted list price and fail to consider the original list price, thereby calculating a higher ratio.

The same is true for analysis of the DOM. If average DOM today is 187 days and a year ago the average DOM was 145 days, a declining market is highly possible. The DOM tool can be adapted to measure the last 30 days compared to the same 30-day period a year ago for a snapshot of the market. The DOM tool can also be problematic because some MLSs calculate from the last list price adjustment

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date and fail to recognize the property's initial presentation to the market, or price changes between brokerages.

The analysis of a sale – resale transaction of the same property can be an extremely reliable evidence of a declining market, as well as, an appreciating market. This tool removes any differences in location, but adjustments are still likely needed for condition, improvements such as remodeling, and transactional differences, such as seller's concessions. This tool is best applied within a spreadsheet grid where the original sale date, resale date are noted, and calculate the difference in years or months.

First, the original sale is adjusted for property rights, financing concessions, condition of sale, and seller expenditures not included in the sale price required to facilitate the sale (such as a new roof, dry-rot repair, etc.) to arrive at an adjusted original sale price. Second, the same line items are applied to the resale price transaction to arrive at the adjusted sale price of the most recent transaction. Next, the difference in sale pricing is calculated *less* any seller's recent improvements (these are improvements that would not be adjusted up for appreciation, such as expansion or remodeling), *plus* any deferred maintenance costs (these are items an owner needed to replace a component or perform some maintenance work but did not) to arrive at an adjusted difference. It is important to consider the contributory value of the improvement or remodeling rather than solely the cost of the project. Finally, the aggregate percent change and percent change per year is calculated. When this technique is applied to several sale – resale transactions it is a very convincing tool in support of negative and positive time adjustments.

Real estate owned (REO) is a very important consideration particularly in small market areas because it can drive the market. REO refers to properties owned by a financial institution. Typically, they are properties having completed foreclosure proceedings. For a financial institution, this can be a heavy burden because the Federal oversight banking system requires greater loan reserves for those institutions, which lessens their operating revenues. Consequently, these institutional sellers are motivated to sell the REO property quickly and many times at well below market prices. To estimate the number of REO properties in a specific market area, the MLS search criteria might include searching the "marketing comments" or "agent comments" section for bank owned property. Online resources are an excellent portal for REO and foreclosures. Some searches can be completed by zip code. The best method to search for these transactions is by public record ownership. When an owner transfers title to a law firm as trustee or lending institution, it is a good indicator the property is an REO.

In conclusion, the appraiser with these additional tools in their toolbox has the ability to look forward in examining market trends. The tools provide the appraiser with forward thinking ability to forecast changes in the market, perhaps before many others realize. It is this same forward thinking a smart investor uses to forecast future economic benefits from income growth and reversion. As with any of the above supply and demand tools, it is not an exact science as is the development of your appraisal opinion. Appraisers tend too much to focus on history and forget about forward thinking. In declining markets as well as highly appreciating markets, the appraiser should look both ways.

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