

DISTRESSED-HOME PRICES: **The True Story**

A recent study of more than 1,000 defaulted properties shows lenders and government agencies lack the tools to properly price the millions of distressed assets now flooding the market. As a result, lenders, investors and taxpayers could lose billions due to inaccurate pricing of distressed properties.

BY NORM MILLER AND MICHAEL SKLARZ

At the heart of every foreclosure, short sale or loan-modification decision is the same critical question: How do I figure out today what this property will be worth tomorrow? ◆ Difficulty in determining future value lies at the center of the debate over foreclosures vs. modifications. It is also one of the principle reasons it now takes weeks or even months for banks to respond to short-sale offers. ◆ More important, when billions of dollars in distressed assets change hands as part of the government rescue of banks, the winners and losers will be separated by those who can best predict future value and those who cannot. ◆ According to our December 2008 study of more than 1,000 distressed properties being held by banks or government agencies, those responsible for pricing distressed assets not only lack the tools needed to reasonably predict the future value of underlying collateral; they are unaware of—or ignoring—the only tools that can accomplish the task: better local market data. ◆ The severity and size of the housing crisis, coupled with the fact that taxpayers are now on the hook for some of the ultimate price tag, means the need for better local market data has now moved beyond simply a debate among economists. ◆ Our analysis—completed in late 2008, and which used a sample of distressed assets in such major markets as Boston, Phoenix, Los Angeles and Miami—uncovered numerous specific examples of both substantial undervaluation and overpricing. What’s more, our analysis demonstrates how these risk-management errors can lead to losses in the millions on even small pools of loans. In one case, one of the government-sponsored enterprises (GSEs) sold a property for \$60,000 only to see the same property come back on the market three weeks later at \$120,000.

Figure 1 San Diego CBSA* Single-Family ZIP Code Price Indexes and S&P/Case-Shiller Index For Selected ZIPs

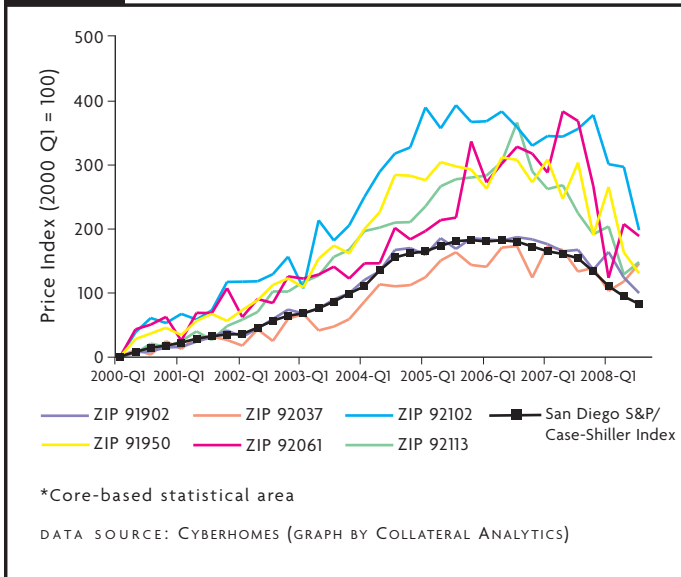


Figure 2 San Diego Single-Family ZIP Codes, 2007 Q3–2008 Q3 Price Change (%)

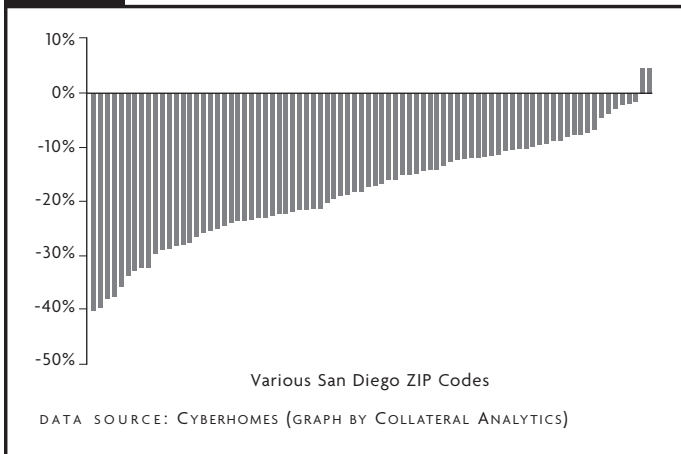
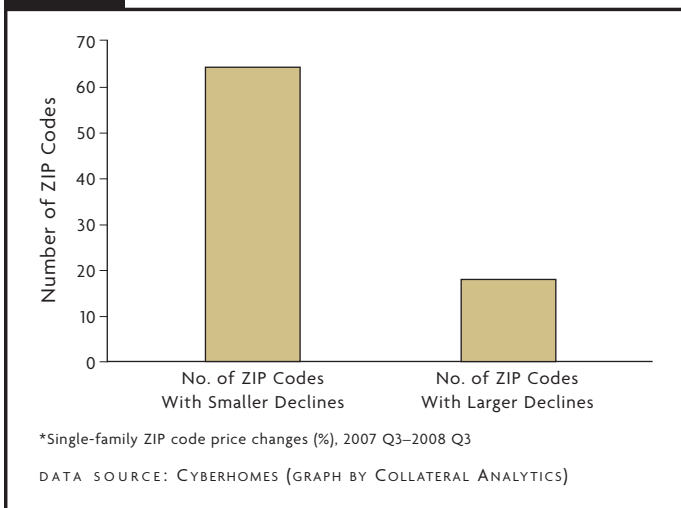


Figure 3 San Diego ZIP Code Price Changes Compared with S&P/Case-Shiller Index*



We found dozens of similar examples where banks substantially undervalued distressed properties because they lacked local market data. We also found dozens of instances of substantial overestimations of the value of distressed properties that would leave properties sitting on the market for months. On one \$400,000 property in a local market where prices were declining by 32.1 percent, this meant losses could approach \$352 a day or \$31,680 over 90 days.

How did we spot these properties? We screened properties that sold quickly or simply sat on the market. We also ran automated valuation models (AVMs) on thousands of properties and then adjusted the value based on local market conditions and back-tested the fit with observed discounts from historically driven AVM models. That is, AVMs use data that are historically anchored, and when market conditions are changing rapidly, the AVM estimates will be off. We need to forecast values based on market trends, normal time on the market, months' remaining inventory and a variety of other indicators, such as the percentage of sales that are real estate-owned (REO) within each local market. We then compared our adjusted forward-looking price estimates with the asking prices of listings on the market.

Key to avoiding undervaluation or overestimation of value is finding reliable local data that can be used to better predict future market direction and value.

Our study revealed that many in the mortgage industry today are making two critical valuation errors that may dramatically compound the housing crisis:

- Relying mainly on traditional valuation tools such as appraisals, broker price opinions (BPOs) or automated valuation models—all of which are backward-looking methodologies; and

- Trying to predict individual future home-price direction by using macro-level data that our analysis shows are wholly inaccurate when applied to specific properties.

As one lender told us, "Right now we are only guessing about future values. We simply don't have the tools we need."

The Federal Deposit Insurance Corporation (FDIC) has tried to help solve the problem by telling lenders and servicers they need to use macro-level models such as the S&P/Case-Shiller Home Price Indexes to determine future value. According to a Nov. 21, 2008, FDIC memo on loan modification, lenders are required to develop net present value (NPV) calculations that rely on appraisals "updated by forecasted MSA-level [metropolitan statistical area-level] home-price changes to date."

The problem: Macro MSA-level economic models are too broad to accomplish the task. As any savvy REO asset manager knows, within the same city, town or ZIP code, there can be dozens of "micro markets" that perform differently. Even the founders of these models would acknowledge that having more local data is always better. See Figure 1 for a comparison of selected San Diego ZIP codes with the S&P/Case-Shiller index.

As part of our study of properties in 25 different states, we developed a method for assessing the condition and direction of local markets defined by limited geographical area and by property characteristics. We compared valuation results based upon these "micro analytics" to those achieved by the use of standard valuation tools and the leading macro-market indexes.

We conclude from the results that the only way to estimate the asset value of residential properties in diverse and rapidly changing real estate markets is to supplement current real

estate valuation methodologies with reliable characterizations of the condition of local markets.

Our analysis shows that while general indexes from sources such as West Chester, Pennsylvania-based Moody's Economy.com and home-price indexes like the S&P/Case-Shiller index may provide excellent macro-data tools for predicting the general direction of housing markets on a state or nationwide basis or for large MSAs, these indexes can be inaccurate and misleading when used to predict the price direction of specific properties within the tens of thousands of micro markets that make up the U.S. housing market. Figure 2 shows where the majority of all ZIP codes suggest price declines far less than that of the S&P/Case Shiller index in the San Diego MSA. Figure 3 illustrates how several of the more homogenous ZIP-code-level submarkets have fared better than the S&P/Case Shiller index would suggest.

As the current situation changes and some neighborhood markets begin to improve while others—perhaps even in the same ZIP code—continue to fall, reliance upon macro-market price-trend forecasts incurs even greater risk for valuation errors. All of this matters because loan modifications will occur

to this task, based on the way local real estate markets work and the evidence we present here.

Current house-price predictions: Great headlines, right data?

As Mark Twain wrote, quoting Benjamin Disraeli, "There are three kinds of lies: lies, damned lies and statistics." With Twain's Disraeli-stylized skepticism regarding statistics in mind, should we consider that a 55 percent decline in Santa Barbara, California's median price means all homeowners there lost more than half the value of their homes?

Or should we assume that a 28 percent annual house-price decline in Miami (according to the popular S&P/Case-Shiller index) means that all homes there are now worth 28 percent less?

Statistics may not lie outright, but they can be hollow. Today's housing news is full of examples of misinformation, exaggerations or even outright falsehoods.

Extreme views grab attention and that will never change, but our concern is that the data behind the headlines are often part of the problem and, as a result, we are entering a period of contagion effects where psychology impacts the downward

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at the pace policymakers want only when lenders are able to "conduct an analysis of whether a loan modification would present greater value before proceeding to foreclosure," according to the FDIC's Nov. 21 press release on meeting the needs of creditworthy borrowers.

In other words, lenders must be able to compare recoveries obtainable by modifying a mortgage loan with those expected from foreclosure, and determine that modification will result in greater value. This cannot be achieved without coming up with a credible, documented analysis of how future value was determined.

Without the analysis or documentation, servicers and lenders will fall back on the foreclosure option or make huge mistakes on the modification option. This could trigger the continued wrath of investors and potential class-action lawsuits. Reliable local indicators of future price trends, such as months of inventory or shadow inventory, can dramatically change appropriate pricing decisions even if the subject properties are exactly the same and have the same current value. (See our 1986 article in the *Journal of Real Estate Research*, "A Note on Leading Indicators of Housing Market Price Trends," for the first paper written on using multiple listing service [MLS] data to predict future price trends.)

Furthermore, in many cases these net-present-value asset analyses must also be sufficiently reliable to support modification decisions that comply with the lender's or servicer's securitization agreement obligations. Traditional "present market price" tools and macro-market indexes are wholly inadequate

housing slide as much as fundamentals.

The widely followed S&P/Case-Shiller index makes headlines every week or two. But the index exaggerates price declines because it includes both normal non-distressed sales and bank REO foreclosure sales, which often represent huge discounts to actual market prices. These comparisons are skewing the results downward in the development of this index for price trends.

The weighting system attempts to hold year-2000 initial sale weights constant, so more expensive homes have more weight. Several filters attempt to screen out non-arm's-length transactions and foreclosures, but foreclosures that are later sold as REO by banks are included as repeat sales. In markets with a lot of foreclosures that become REO, we will get an unusual and likely negatively biased impact on the price index. Further, in markets with a lot of new homes, the index will be biased toward older homes that have sold twice—and so the index is less representative of the typical home in that market.

Impact of foreclosed sales on the San Diego S&P/Case-Shiller index

The S&P/Case-Shiller index is not fully transparent. A number of filters are used to try and purify the sample. The weighting systems and criteria, such as significant deviations in price from an S&P/Case-Shiller index AVM estimate of value, are inherently "black-box" and difficult to replicate without the assistance of the S&P/Case-Shiller toolbox. The market needs transparency and the ability to

independently replicate results.

The California Association of Realtors® (C.A.R.), Los Angeles, perhaps in an attempt to not contradict current trends so as to become more credible, has, probably, overcompensated when it produced a report using median prices that had some of the following results based on changes from peak price months (as noted in parentheses) through June 2008:

- Monterey County (August 2007), down 55.0 percent
- Santa Barbara County (June 2007), down 54.8 percent

There is no question that the composition of those homes that sold in Santa Barbara is more biased toward lower-priced homes than was the case in 2007. The actual price decline for the more expensive homes in Santa Barbara is closer to 10 percent than 55 percent, although buyer exposure to such media reports fosters an attitude that feeds into a much tougher negotiating position.

Whatever listing price buyers observe, they will offer substantially less money, citing the validity of market research from C.A.R. or San Diego-based DataQuick Information Systems (www.dataquick.com), which are not adjusted for property size or composition.

Conclusions

Our major conclusions remain constant: Housing markets do not turn on a dime, and they are not national or metropolitan in scope.

Rather, housing markets are granular and localized. Housing within ZIP codes doesn't move in perfect correlation with the metro market; neither do housing prices in different neighborhoods within a single ZIP code necessarily move in lockstep with the overall ZIP code. Local Realtors know this, and divide up MLS markets into neighborhoods that are subsets of ZIP codes or crossover ZIP codes.

This kind of micro detail is the level of market-data analysis required to really know what is happening to the value of a particular home. No one owns the "median house" in America, and most homeowners who don't panic and sell will come out of the current market in fine shape.

But we are not about to suggest that now is a good time to buy everywhere; some markets will continue to slide while others improve. At the neighborhood level, some markets may have farther to fall while others may have already started climbing, and may continue to do so if they can avoid the con-

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Another popular house-price index, the quality-adjusted Office of Federal Housing Enterprise Oversight (OFHEO) House Price Index (HPI), has the problem of not covering the upper-priced markets—especially in California, where many mortgages are above conforming loan limits. Plus, the OFHEO HPI significantly lags the market, making it less applicable for understanding current market trends.

There are two limitations of the OFHEO HPI. First, only conforming loans from Fannie Mae or Freddie Mac transactions are included, limiting the sample to those with mortgages of less than \$417,000 as of 2007, \$625,500 in 2009, and at far lower limits in earlier periods. This price limit is sufficient in areas with low density, cheap land and more affordable housing, but severely limits the applicability to higher-priced markets such as most of California or metro markets such as Boston or New York.

At the national level, homes from expensive markets will be severely under-represented in OFHEO's House Price Index. A second disadvantage of this approach is that repeat sales represent on average only about one-fifth of all sales, so most of the sales data is tossed away.

tamination of irrational despair.

Appraisals and other "present market price" valuation tools and macro-market price-trend indexes must be replaced by data and analytics that provide lenders and servicers with the ability to value real properties as assets over time. By combining local, property-specific data with sophisticated analytics that extrapolate trends actually affecting particular properties, micro-market metrics can provide financial institutions with more accurate and more complete information with which to make better recovery decisions. By doing so, we can minimize losses to lenders, investors and homeowners. **MB**

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