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Bubbles, Buying and Bank-Owned Sales

By Jack C. Harris

What spawned the housing bubble? Who pays less for housing: investors or regular homebuyers? Does emotion influence sales price? How do short sales affect the market? These and many more questions were answered at the 2009 meeting of the American Real Estate Society, where some of the latest academic research was on display. Here are some highlights.

Yes, There Was a Bubble

Just a few years ago, housing markets were humming. Looking back from the perspective of the current collapse, it is clear that there was a market "bubble." That is, home prices rose beyond a level that could be explained by corresponding improvements in economic fundamentals. At the time, some felt the higher prices were justified because of historically low interest rates and the ease with which homebuyers could arrange financing. Bubbles are born in this type of environment, when buyers overbid in the belief that prices will continue to rise.

Two researchers at CERGE-EI, a Czech university, provided evidence of bubbles in the U.S. housing market. Vyacheslav Mikhed and Petr Zemčík not only documented the latest cycle but found signs of a bubble in the late 1980s as well (remember the big construction boom in Texas prior to the collapse in oil prices?).

Using the price index compiled by the Office of Federal Housing Enterprise Oversight, they analyzed both national and local markets from 1978 to 2007. The results pegged the latest bubble as beginning in 2000 and ending in 2006. The succeeding correction continues through the end of the data series. The authors assert the national market completed the downturn in 2008, but some areas of the country may have further to go.

Investors' Role in Bubble

Does sales price depend on whether a property is purchased for investment or for consumption? Some believe that investors can take advantage of owner-occupants when buying or selling homes. Investors probably have more market experience and are better informed on current prices. Presumably, investors are more objective, reducing the decision to a purely financial one.

Those selling their personal residence or buying a new one may be more influenced by emotion. After all, the home was or will be an intimate fixture in the owner-occupant's life.

Some buyers are afraid of being shut out if prices rise further, and sellers may fear not being able to sell in time to close on a new home. Buyers sometimes fall in love with a particular house, or just tire of looking, either of which might handicap negotiations.

Michael Rehm of the University of Auckland took advantage of a uniquely rich database maintained by the City of Milwaukee to examine the influence of emotion on sales prices.

He analyzed 33,000 home sales for the period 2002–07. The database allowed him to identify with some confidence whether the parties were investors or owner-occupants. Rehm sorted the sales into categories: owner to owner, owner to investor, investor to owner and investor to investor. He then ran a statistical analysis to test whether these categories have any significant effect on sales price, controlling for differences in house characteristics and location.

Analysis of the whole market revealed homebuyers paid a premium (an amount over and above an expected price) while investors got a discount when buying, both of which increased over time. Rehm then divided the market into inner-city neighborhoods and suburbs, noting that Milwaukee has a highly segregated housing market. Prospective homeowners in the inner city may pay a higher premium compared with suburban buyers because the former have a more limited supply from which to choose. Investors would not be as subject to such restrictions. The results show the premium was indeed higher in the inner city (27 percent) compared with the suburbs (14 percent).

Rehm's study indicates market prices were pushed upward by the willingness of owner-occupants to outbid investors and pay a significant premium. He points out investors buying distressed and damaged properties to flip paid depressed prices and contributed to the observed discount.

During the housing boom, some market observers felt investor-speculators were driving up home prices. This study offers evidence that investors actually paid lower prices.

Could desperate homebuyers armed with subprime financing have caused the problem? Of course, the activity of investors did cut into supply, squeezing homebuyers further. Inner-city buyers, already faced with limited choices of properties, would have been especially affected, as rental homes would be expected to come from the lower end of the price range. This research shows homebuyers were willing and able to pay the higher prices, until they finally could not, and the market collapsed.

Rise of the Short Sale

Research is beginning to delve into the downside of the housing cycle. Short sales are one symptom of deteriorating market conditions. A short sale occurs when a lender agrees to accept less than the outstanding balance to retire a mortgage debt. This acquiescence allows the home to be sold at a competitive price and avoids the need for foreclosure.

The trick for the lender is to reserve this concession for cases in which foreclosure is inevitable. Therefore, lenders may require borrowers to document their inability to maintain debt service, show the house was on the market for a specified period at a price sufficient to pay off the loan, and may require limitations on the broker's commission.

The listing broker knows about the possibility of a short sale and its likely effect on marketing time and commission rate. Many local Realtor boards require this information to be conveyed to cooperating brokers as well.

The National Association of Realtors reported that 40 percent of Realtors were involved in at least one short sale in 2007. In a first attempt to throw light on the short sale, Professor Steven Schultz of the University of Nebraska at Omaha analyzed data from the Omaha housing market for 2003–08.

Almost all short sales occurred in 2007–08, the final two years of the study. Of the listings identified as potential short sales, 38 percent sold.

The Omaha market is not prone to a widely ranging price cycle, so the likelihood of getting "upside down" on a mortgage loan because of a big drop in prices is low. Homeowners in the study were in trouble because they had little equity when they originally purchased the home.

Seventy percent of the sales were homes purchased with no-money-down loans, 54 percent had been refinanced to extract equity, and 26 percent had home equity loans. Even a modest drop in market prices was sufficient to wipe out any equity accrued.

How do short sales affect the overall market? Research indicates a largely positive effect in that price discounts are lower than they would be under foreclosure.

Previous studies have estimated homes going through foreclosure sell at a discount of about 20 percent. Schultz estimates the short sale discount by comparing sales price to appraised value and by statistically modeling the sales prices of all homes sold. The discount is estimated at 8.5 percent by the appraisal method and 10.3 percent from the model. Therefore, the availability of short sales does benefit the lender and moderates the depressing effect of distressed sales on market prices.

Effect of Foreclosures Ambiguous

When a short sale cannot be arranged, the likely result is foreclosure, repossession by the lender or loan insurer and sale as REO (real estate owned) by the lender. Lenders always have some REO inventory, but in recent years growing numbers of foreclosures have made such sales more common. Widespread sales of distressed homes not only cause individual neighborhoods to decline but may put downward pressure on prices for the whole market.

To measure how REO sales affect housing markets, Professor Thomas Jackson of Mays Business School at Texas A&M University looked at home sales in a selected set of Indianapolis neighborhoods. During the study period (2000–08), REO sales went from less than 1 percent to over 50 percent of all home sales. A statistical analysis was applied to measure how much an REO status lowered a home's sales price. As found in earlier studies, the discount is around 20 percent.

Jackson notes that as REO sales increased, the prices of both REOs and other sales declined. This could indicate that foreclosures depress the market prices. However, it could be that all home sales are being affected by external factors, such as rising unemployment and contraction of credit markets.

The analysis was unable to support one possibility over the other. More than likely, a complex feedback process occurs in which market conditions lead to more foreclosures, which eventually bring more REO sales into the market, increasing supply at a time when demand is falling, thereby depressing prices.

The study documented that marketing time for REO sales is half that for other sales, so having this inventory on the market does help clear the market and stabilize supply and demand.

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More Information on These Studies

"Do Home Prices Reflect Fundamentals? Aggregate and Panel Data Evidence," Vyacheslav Mikhed (vmikhed@cerge-ei.cz) and Petr Zemcík, CERGE-EI, *Journal of Housing Economics,* 18(2), 140–149.

"Different Strokes: Does Buyer-Type (Investor versus Owner-Occupant) Influence House Prices?" Michael Rehm (m.rehm@auckland.ac.nz), University of Auckland.

"Short Sale Brokerage Listings for Distressed Properties," Steven Shultz (sshultz@mail.unomaha.edu), University of Nebraska-Omaha.

"The Effect of Foreclosures on Residential Property Values," Thomas Jackson (tjackson@mays.tamu.edu), Mays Business School, Texas A&M University.

THE TAKEAWAY

Recent real estate research offers evidence that there was indeed a market bubble from 2000 to 2006; that investors pay less for homes than regular homebuyers do; that short sales benefit lenders more than foreclosures; and that marketing time for bank-owned homes is half that for other sales.

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