

Home Values: Mortgage Qualification Enemy #1?

MORTGAGE LENDING HAS EXPERIENCED unprecedented change over the past 36 months. The public perceives – and rightly so – that lenders and regulators have over-compensated in a time of crisis. The pendulum has shifted from a market that once accommodated most any borrower – regardless of credit or income – to one where even well-qualified borrowers may now have more difficulty purchasing or refinancing; difficulty that does not center on credit, income, or assets but on collateral. Common sense dictates that as market fears subside, this pendulum will start to move back toward center. One Achilles Heel that continues to limit financing opportunities is the widespread decline in property values and subsequent problems that arise when current value does not meet the lender’s minimum collateral requirements. This trend is accented by mounting foreclosures and distressed sales throughout the Chicago metro area.

In theory, the appraisal process is designed to be 90 percent science and 10 percent art. In practice, that balance may vary based on appraiser experience and knowledge of a particular community, property types, neighborhood characteristics, and underwriting requirements to name a few. Prospective borrowers should understand the uniform methods and principles used by licensed appraisers and hopefully gain a clearer understanding and appreciation for how subject property is viewed in today’s market compared to years ago.

Estimating value

There are three approaches to estimating value: cost, market, and income.

The cost approach:

The fundamental premise is that a potential occupant should not, or will not, pay more for real estate property than it would cost to build an equivalent structure on similar property. The cost of construction minus depreciation, plus land, therefore is a limit, or at least a metric, of market value. The cost approach is used primarily with new construction.

The market approach:

The market or sales comparison approach, most commonly used today, is based on the principle of substitution. A prudent individual will pay no more for a property than it would cost to purchase comparable property. A typical buyer will compare list prices and purchase the property that meets their wants and needs for the lowest cost through negotiation. In developing the sales comparison approach, the appraiser relies primarily on comparable property (within a one mile radius) that has sold within the past three to six months. Lenders require at least three recent sales and two current listings although listings carry much less weight.

Herein lies the dilemma today for many borrowers – particularly those who have invested a great deal of money into home improvements that may not otherwise result in a higher appraised value given current trends. The borrower then falls short of the necessary value required to sell (short-sale), refinance, or subordinate an existing home equity line of credit.

All too often there have not been sufficient sales to develop an opinion. Or, if there have been, they are not truly comparable, and wide adjustments in value and time need to be made. While short sales and foreclosures create buying opportunities, they also submerge the value of other homes in a neighborhood.

The income approach:

The income approach is used for investment property. Net income generated by the property is used in conjunction with other factors to estimate value.

Perform due diligence before refinancing

If your appraisal falls short of the required value, you may forfeit the cost of the appraisal and walk away with no other out of pocket expenses except credit report costs. Here are some suggestions to help mitigate your risk and perhaps save hundreds of dollars before proceeding:

Contact a trusted, local real estate agent, and



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one that markets to your area, who can give you a professional opinion as to your home’s estimated value based on recent sales. Successful, forward-thinking agents should jump at the chance to forge a new relationship with a potential client.

Check online market valuation tools. When comparing actual appraised values to online valuation websites such as www.zillow.com, results can vary widely. Depending on the neighborhood, we have found the “zestimate” to be both accurate and inaccurate. This site works best for large subdivisions where builders constructed several similar models often referred to as “track homes”.

Prior to 2007, every neighborhood experienced significant increases in property values. Many borrowers now have a difficult time today understanding how their property has declined so rapidly and to such a degree. Increased awareness of today’s process should go a long way toward at least understanding – if not appreciating – the process appraisers and lenders use. 