Market Rigging is it just a Wall Street thing?

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NOT IN ALBUQUERQUE—FOURPLEX FEVER? OR FRAUD?

The better mouse trap.

Anyone who has ever been involved in sales whether shoes, stereos, or stocks has always wanted to find a tool that gives them a competitive advantage over the competition.

At a time when most Americans are questioning the accounting procedures and back boardroom shenanigans of the corporate world, many investors are moving their cash into investments considered more solid and safe. T-bills, gold, and real estate top the list.

As the Enrons, Global Crossings, and WorldComs of the world have shown, there are people and companies that are willing to tell investors what they want to hear, with the perpetual hope that next year they can make what they said true. To be surprised this happens is to be surprised that the sun will rise in the east.

Any investment product counts on the surety of checks and balances in our system. Government regulation, independent audit companies, 3rd party non-related vendors to the transaction and market reactions are all staples of any industry that provide the necessary market mechanisms to correct any excesses.

The SEC was born out of a stock market full of insider trading and market manipulations at the beginning of the 20th century. The ability to regulate, fine and imprison an entire industry allows the SEC a large purview into publicly traded corporate America.

Unfortunately no such market mechanism exists for real estate, otherwise the following scenario might have been prevented.

Imagine a local real estate market stagnant after the heady times and appreciation of the early 1990's. Imagine you are one of two dozen "apartment brokers" in this marketplace, who are fighting for dwindling market share. Imagine unheard of low interest rates, and a market where Sellers are overly willingly to sell.

Fourplex sales in review

Fourplex	1996	1997	1998	1999	2000	2001
Avg $/Unit	$33,319	$34,617	$36,735	$30,394	$32,693	$31,997
Total Units	224	236	204	164	108	224
Total Deals	56	59	51	41	27	56

By all accounts, 2001 should not have been a banner year for fourplex sales—the recent market softness in occupancy and rents and aging product were all weighing against the existing fourplex stock, and yet 2001 was the 2nd best year in volume of sales during the last five years. Further analysis indicated….

Market Manipulation

Only 36 fourplex sales out of 56 appear to be legitimate. From an appraisal standpoint, that means a willing and ready seller and unrelated buyer who are not unduly influenced by outside market conditions.

And the remaining 20? According to MLS records, 14 of the 20 had their list prices "raised" after they had been listed and after they had been put under contract to a prospective buyer. On average these 14 properties had an increase over list price of 23.46%. Since most fourplexes (when they sale), sell for approximately 96% of list price. The reality is that the sales prices obtained for these sales were most likely at least 28% higher than true market value.

Additionally, it is the author's belief that many of these fourplex sales would **never** have occurred legitimately as the original list price of these fourplexes was in excess of current sub-market comparable sales.

If more people were involved it would be a conspiracy…..

A NM Apartment Report Publication

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Fourplex Fraud?

Typically for a scenario like this to be pulled off, an appraiser, a title company, a real estate broker, and a mortgage broker would all have to be in cahoots, with possible co-conspirators in fellow real estate agents, buyers and sellers.

The reality is it takes only two to tango…

And here is where the checks and balances fall down.

Typically, the mortgage broker is given a set of instructions by the "investor" who intends to purchase the loan once it's secure. This checklist includes inspections, appraisals, review of title, verification of buyer's down payment proceeds, etc. Since the title company owns allegiance to the transaction, the listing agent to his seller, and the buyers agent to the buyer, the mortgage broker and appraiser are typically the two individuals who bear the brunt of making sure the deal is financially viable.

If the mortgage broker, who happened to be the buyer's agent (collecting on average a mortgage brokerage fee and sales commission of $10,000 per deal), were to hire an appraiser who did minimal checking of the basic facts, and that mortgage broker signed off that all items on the checklist were complete, then VOILA! a deal is made.

Everybody gets what they want—The seller sells a property for list price, the listing agent collects his fee, the title company theirs, the buyers agent/mortgage broker his, the buyer gets into that eternally hoped for NO DOWN DEAL, and the deal closes. But is it in the best interest of the property to carry 125% of its value in debt?

So what is "Viable?" - according to the American Heritage dictionary—Viable is defined as:

Capable of success or continuing effectiveness; practicable: *a viable plan; a viable national economy*. See synonyms - possible.

So for the sale of a fourplex to be viable for the next buyer, means that the property needs to be able to continue in its existing status, a condition that brings in sufficient income to pay expenses and service debt.

And that part of the story remains so far, unwritten….

As the transactions are fairly recent, not enough time has passed to tell if these deals can withstand the test of time. Possible in a perpetually and rapidly appreciating market like California, deals like this could be swept under the rug, but in a plodding fourplex market, these sales will eventually become unwound… leaving a trail of victims.

Where is the body?

Is it a victimless crime? Calls and letters to industry watchdogs have been replied with "interesting but who is hurt by this? - where is the victim?"

The buyer– according to Daniel Boardman, noted author about common scams, the next step for most buyers is to stop making payments, file bankruptcy and continue to collect income from the property without meeting debt service obligations—no matter what you might see on Cable TV late at night—this is not a long-term path to wealth.

The lender (s)- once the buyer stops meetings its debt service obligation, the lender must declare the property non-performing and initiate foreclosure.

The insurance– if the lenders were informed that two loans were used causing a high loan-to-value, then yes good old mortgage insurance premiums, insurance bought to cover high loan to value loans will payout to the lender, causing MIP rates to increase for everyone.

The appraisal industry-honest appraisers, unwittingly might use dishonest and inaccurate fourplex sales, further bolstering a market that does not have the basic market dynamics to support increased values.

The real estate industry-While real estate agents are rated higher than lawyers and most CEO's today, the publicity from this fraud causes a black eye on the industry, unless it moves fast and furiously to correct it—(remember an industry that polices itself does not need to be policed by the government).

The market- Can future fourplex sales be based on fraudulent comparable sales? Will sellers bring to market fourplexes at a price considerably higher than buyers are willing to pay?

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FOURPLEX FRAUD?

The neighborhood- What is the impact on Neighborhoods? As the marginal properties decline, the buyer will be obligated to spend more and more to keep them in good condition. And yet, if they forego making debt service obligations, then their ownership interest is for a short period of time, discouraging them from investing in capital items to keep the properties in good repair. Rents decrease, the buyer cares less about the tenant's qualifications, and the neighborhood declines as the criminal element moves in.

The solution

Several solutions exist

1. Buyers need to become more educated about the market and alternatives, and they need to understand that it takes money to make money
2. Lenders need to treat real estate more like an asset than an actuary table. Recent industry movements have been to eliminate the appraisal process entirely, a bad idea, as the appraiser is often the lenders only ambassador to the property, who makes sure that it actually exists
3. Disclosures—title companies should require disclosures to all parties that a mortgage broker/ buyers agent are wearing the same hat.
4. Qualifying brokers for real estate firms need to be held more directly accountable
5. Real Estate Trade Associations and Multiple Listing Services need to setup "Watchdog" committees to troll through transactions conducted through association property (i.e. online listing services, flyers, etc.) and spot possible fraud while in progress.
6. Real Estate industry/community watchdogs—need to jump on an issue when presented—granted white collar crime is not as exciting as watching an episode of ***COPS,*** whether someone witnesses or is stuck by it, when a tree falls in the forest, that tree is still down. When a crime is committed, whether the victim is obvious or not, it's still fraud.
7. And last but not least, the greed of the seller to sell at list price, the buyer to get into a deal nothing down, and the agents to complete the deal is what keeps a transaction like this well greased to the closing table.

And yet….. The market goes unchecked
One can only hope this mouse trap catches the rat that sprung this invention on our marketplace.

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