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Just what is the market and why is it behaving so oddly?

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These days, the word "market" is bandied about with the assumption that everyone knows what the word means. I must admit that I myself am guilty of this transgression. Looking through my appraisal reports, I find that I write phrases such as "the market is strong," "the market is weak," "the market is stable," or any other substitute descriptive of the day. Other phrases often heard are, "it's a buyer's market" and "it's a seller's market." The question remains: just what is the market, and why is it behaving so oddly right now?

To answer the question, an examination of the component parts is helpful. Just who makes up the market? In real estate, the market has two primary participants: buyers and sellers. As we all know from our first appraisal or real estate course, the distilled definition of market value is willing buyer, willing seller. Buyers want to purchase a property at the lowest price possible, and sellers want to sell their property at the highest price possible. The primary level is simple enough in that the buyer and seller are on par with each other. Beyond the primary level, the situation starts to get much more interesting and complex.

To facilitate the buying and selling of real estate, the real estate brokerage profession has evolved. The real estate broker brings together the buyer and seller and typically receives a commission for their work based on the sale price of the property and is paid by the seller. The broker usually represents the seller; however, a relatively recent development is the concept of the buyer broker who represents the buyer. The buyer broker also is paid, usually based on a commission paid by the seller, but other arrangements are possible. Because brokers are paid a commission based on the sales price, the higher the sales price, the greater the commission. Under the circumstances, this secondary level heavily leans in favor of the seller

Again, to facilitate the buying and selling of real estate, the mortgage industry has evolved. Unless all cash is paid for a property, the buyer of real estate applies for financing to borrow funds over the ownership period using the purchased property as collateral for the loan. The mortgage industry contains a wide variety of players including, but not limited to, a mortgage broker, the loan officer, and the financial institution. In this formula, the mortgage broker and loan officer are paid a commission based on the amount of the loan. The greater the amount of the loan, the greater the commission.

The financial institution is the source of funds. The financial institution wants the loan paid back in a timely manner. If a buyer defaults on the mortgage, the financial institution becomes the owner of the property, an undesirable event. A mortgage is typically made based on the strength of the buyer/borrower. Under the circumstances, this tertiary level favors the buyer in that the financial institution does not want to lend to a party that cannot repay the loan.

The fourth level of the market consists of those participants who assist the mortgage industry in the decision making process by providing information. These participants include the real estate appraisers, home inspectors, the title researchers, the credit bureaus. These participants are paid a flat fee regardless of the value of the real estate or the loan and are considered disinterested third parties.

When all participants perform their individual jobs with due diligence, the market is in balance. When one party starts to falter, the strength of the other participants has the ability to rein in the aberrant player. When more than one party falters, a cascading effect may ensue, and the system becomes unbalanced with devastating consequences. This is the situation we find ourselves in today.

During the giddy days of 2004 through 2006, almost anyone could obtain a mortgage. In retrospect, the most inane product was the NINA loan - no income, no asset - where the borrower did not need to provide proof of income or assets in order to obtain a mortgage. Because property had been appreciating at rates well above inflation, some participants within the mortgage industry believed that appreciation would more than make up for any loss in the event of default. The giddiness was not just within the mortgage industry, but much more widespread throughout the market. Looking back on our behavior as market participants we can ask, "What were we thinking?"

No easy way out of this mess exists. No government bailout is big enough. We need to work through the problems and get back to balance through due diligence. We have a lot of work ahead of us.

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