Best Practices for Loans Involving Possible Property Flips

Freddie Mac
We make home possible®

Reprinted from Attachment A of the October 9, 2009 Guide Bulletin 2009-24
(www.FreddieMac.com/sell/guide/bulletins/pdf/bll0924.pdf)

Transactions that Freddie Mac Considers to be Property Flips

The term property flip refers to a transaction in which a property is purchased and quickly resold for a significant profit. A large increase in property value coupled with a short time period between transactions may indicate that the property is being flipped. Properties targeted for property flips generally include properties that can be acquired at lower prices than other properties in the same neighborhood and often include real estate owned (REO) properties, properties subject to a "short sale", other distressed properties or newly constructed properties where the builder or developer must liquidate housing inventory quickly. A property involved in a flip may be resold on the same day or within days, weeks, or months of the purchase. In some cases, the seller of a property flip never holds title to the property, but instead sells or assigns their interest in a contract to purchase the property to a third party.

Property flips are not inherently illegal and not all transactions involving a rapid purchase and resale are improper. Legitimate property flips are acceptable transactions in connection with loans purchased by Freddie Mac. Some indications of property flip transactions that may be legitimate include:

- Sales of properties by a Government Sponsored Enterprise, state or federally chartered financial institution, mortgage insurer, or federal, state or local government agency
- Property sales by employers or relocation agencies related to employee relocations
- Sales of properties that are acquired by the property seller through inheritance, divorce, or as a result of a legal settlement or proceeding
- Sales of properties that have been substantially improved by bona fide and verified renovations since the property was acquired by the property seller in which any increase in sales price over the seller's acquisition costs is representative of the market given the improvements to the home
- Sales of properties that the property seller acquired at below market value after purchasing as a result of a distress sale (i.e. REO sale, short sale, tax lien sale, bankruptcy trustee's sale, etc.), where any increase in the sales price over the property seller's acquisition cost can be clearly shown to be a result of the difference (if any) in the market's reaction to distress sales and typical arms-length market sales.

Characteristics that are red flags for improper "Property Flip" transactions

Certain characteristics of a transaction may be red flags that may be indicative of an improper property flip scheme. These characteristics include, but are not limited to:

- Appraisal lacks sufficient analysis of all pertinent offerings or listings for the subject property, the contract of sale for the subject property, and the sales/transfer or listing history of the subject property and comparable sales
- Comparable sales or listings used in the appraisal report are properties involving the same property seller and/or real estate broker as the subject property in an attempt to create an artificially inflated market
- Transactions in which the property seller or any other party claims that the property was significantly renovated since being acquired by the property seller but the claimed renovations were not actually performed or cannot be sufficiently documented. Improper transactions often use inflated appraisals that falsely claim to be justified renovations.
- Transactions in which there appear to be unusually large profits for the property's market area without appraisals that provide a reasonable explanation and justification for the large increase in property value.
- Transactions in which the property was acquired by the property seller as a part of a distress sale in which the property seller, or a related party was a party to an option contract to purchase the property from the prior owner for an option price substantially below actual full market value. The option contract and the true market value of the property are typically not fully disclosed to the prior lender.

- Transactions in which the property seller, or an agent representing the seller, arranges or assists in arranging financing, settlement services or the appraisal, including some cases where the property buyer and seller are represented by the same real estate agent or broker (dual agency). Some improper transactions result from collusion between the seller, real estate broker, lender/loan officer, and appraiser to defraud an unwitting buyer.
- Transactions in which the contract seller is not the current owner of record.
- Undisclosed "simultaneous", "double", or "back to back" closings or escrows.
- Purchase transactions with undisclosed secondary financing, in which part of the purchase price is refunded to the buyer, or is quickly followed by a cash-out refinance. Such payments may or may not be reflected on the HUD-1 settlement statement.

Best Practices for Loans Involving Property Flips or Suspected Property Flips

To assist Seller/Servicers in their responsibility to ensure that any Mortgage involving a property flip or suspected property flip meets our definition of an investment quality Mortgage, Freddie Mac recommends that they consider adopting the following best practices:

Appraisals

- Use Loan Prospector® feedback messages to help ensure that the property value submitted to Loan Prospector is accurate and supported. The excessive value message notifies the Seller when the stated subject property value is potentially excessive compared to local market property values. The REO history feedback message identifies subject properties that have been in an investor REO portfolio in the past 24 months. The rapid appreciation message notifies Sellers if the estimated value of property or net purchase price reflects an appreciation in value faster than the surrounding market. If Loan Prospector provides any of these feedback messages, carefully review the appraisal.
- Obtain a full appraisal with an interior and exterior inspection reported on the form appropriate for the property type being appraised. Additionally, be particularly selective in choosing appraisers who are familiar with the subject property's market area and are competent to appraise properties involved in complex transactions.
- Use automated valuation models and other collateral risk assessment tools in the origination and pre-funding quality control process to detect fraud and objectively measure the accuracy of the appraisal. Freddie Mac recommends the use of Home Value Explorer® (HVE), Home Value Calibrator® or other validated and tested AVMs, as well as other collateral valuation tools. More information about HVE and Calibrator, and a list of distributors, can be found at http://www.freddiemac.com/hve/.
- Ensure that the appraised value is adequately supported by market data and that appropriate comparable sales were utilized in the appraisal report. Make certain that the underwriters or reviewers who evaluate appraisals involving questionable transactions have experience, training and knowledge related to property flip transactions.
- Ensure that the appraisal sufficiently analyzes all pertinent offerings or listings for the subject property and includes sufficient analysis of the contract of sale for the subject property. Pay special attention to the appraiser's comments and analysis to determine if the appraiser provided adequate justification for any significant increase in sales price/value over the seller's acquisition costs. This analysis should be detailed enough to clearly explain the methodology and rationale used to justify the appraiser's conclusions on this issue. A statement by the appraiser that the new appraised value is justified by the current market conditions without detailed analysis and discussion is not sufficient.
- Ensure that the appraisal lists any changes made to the property and includes photographs of the rehabilitation or renovation whenever an increase in sales price/value is justified in whole or part by improvements made to the property. Obtain further documentation that such improvements were made after the property seller acquired the property. Such documentation could include copies of receipts, contractor invoices, building permits issued or other similar documentation.

- Perform additional due diligence by obtaining either a field or desk review of the appraisal or a second appraisal if the Seller suspects that the increase in sales price/value is unreasonable or unusually large within the context of the property's market.

Miscellaneous Underwriting/Closing/Title Issues

- Perform additional due diligence in reviewing the chain of title of the property including a search of the public land records for any recorded options contracts on the subject property and research any recent title transfer activity. Exercise additional due diligence to reconcile any differences in the owner of record as reported in the appraisal or any other documentation including the title report.
- Exercise additional due diligence when analyzing sales contracts and other documentation. Carefully analyze sales contracts looking for terms indicating there has been assignment or sale of the seller's interest in a contract or option to acquire the property.
- Draft additional closing instructions designed to prevent title companies and/or attorneys from conducting two or more closings in quick succession without prior approval.
- Analyze and review estimated and final HUD-1's for unusual payments to parties not having a recorded interest on the property and abnormal real estate commission payments.
- Include effective provisions within Seller's quality control programs designed to detect transactions that are property flips and evaluate such transactions to detect transactions that are improper. Report suspected cases of fraud to appropriate agencies.
- Train all employees and personnel involved in the loan production process and the quality control function on the issues regarding property flips including the characteristics associated with improper property flips.