

# Differences Between Neighborhood and Market Areas & Analysis

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When examining appraisal reports, it is commonly noted that the Neighborhood section of the 1004 appraisal report contains data for sales of properties that are comparable and competing to the subject, rather than for sales of all homes of the same category (i.e., single family detached).

Professional appraisal reference works, such as *Appraising Residential Properties, 4<sup>th</sup> Edition* (published by Appraisal Institute) address the differences between a “neighborhood” and a “market area.” Further, various Fannie Mae selling guides and announcements, and the HUD 4150.2 handbook contain guidance for appraisers regarding the analysis of neighborhood and market data, and what is expected to be reported in the Neighborhood, Inventory Analysis and 1004MC sections of the appraisal report.

This document contains excerpts from these publications with relevant portions highlighted for easy reference. Additionally, comments and observations have been included to assist in understanding their applicability to the topic.

## Professional Appraisal Reference Works

*Appraising Residential Properties, 4<sup>th</sup> Edition* contains discussions of “neighborhood” and “market area” on pages 36, 78 and 198. The statements contained therein indicate that data and analysis related to a **neighborhood** is broad and general in nature, whereas data and analysis related to a **market area** is specific and related to a particular property type or category. Some of the statements appear below (**bold** added for emphasis).

- *Appraisers make a distinction between the **neighborhood** in which a residence is located and the **market area** in which comparable properties will be found. The latter (**market area**) is formally defined as “the geographic or locational delineation of the market for a specific category of real estate, i.e., the area in which alternative, similar properties effectively compete with the subject property in the minds of probable, potential purchasers and users.” In contrast, a **neighborhood** is defined more generally as “a group of complementary land uses.” In other words, **the neighborhood boundaries in which the subject property is located may contain residential properties that are not comparable to the subject as well as commercial properties that serve the residents of the neighborhood, whereas the boundaries of the market area for the subject will be defined first and foremost by the proximity of comparable properties.** In some cases, the subject’s neighborhood and market area may have concurrent boundaries, but in others the market area may contain several neighborhoods or portions of different neighborhoods.*
- *A **neighborhood** is an area of complementary land uses. The term neighborhood suggests a **variety** or balance of complementary land uses.*
- ***Broad market conditions** provide the background for local and **neighborhood** market influences that have a direct bearing on the value of the subject property.*

- *The **market area** is the area in which properties effectively compete with the subject property in the minds of purchasers. A **market area** is defined by the type of property, the type of transaction (rental or sale), the geographic area in which competition exists, and the homogeneity of properties within its boundaries.*
- ***Market analysis** is defined as the study of real estate market conditions for a **specific type of property**.*

*Market Analysis and Highest and Best Use*, published by Hondros Learning, states the following on page 12:

- *Market analysis needs to be done in **general** covering the conditions in the marketplace for the area where the property is located, and also on a **specific** level for the particular property compared with all the other properties against which it competes in the market.*

## Fannie Mae (FNMA) Selling Guides and Announcements

FNMA does not address the difference between “neighborhood” and “market area” as directly as HUD, and in fact blurs the distinction between the two by occasionally using the terms interchangeably. Verbiage on the 1004MC Market Conditions Addendum further clouds the issue.

Nonetheless, statements made in the FNMA Selling Guides are instructive. For example, statements are made which are in line with the previously considered information from *Appraising Residential Properties* regarding the differences between “neighborhood” and “market area.” Several examples are shown below (**bold** added for emphasis).

- *Section XI, 304.01. “in the neighborhood section of our appraisal forms, the appraiser reports on **general neighborhood trends**.”*

*Comment: This statement makes reference to “general” trends, as opposed to trends that are specific to properties that compete with the subject property.*

- *Section XI, 308. “If there is a lack of **truly comparable sales in the neighborhood**—either because of the level of rehabilitation or the relatively low number of sales transactions—the appraiser may need to analyze and use as comparable sales not only **less similar properties from the subject neighborhood**, but also properties from competing neighborhoods.”*

*Comment: This statement indicates that “truly comparable sales” are a subset of all sales in the neighborhood, and acknowledges that “less similar properties” may exist in the neighborhood. This illustrates that differences may (and usually do) exist between neighborhood data for one-unit housing, versus market area data for one-unit properties that compete with the subject.*

- *Section XI, 403. “Neighborhood characteristics and trends also influence the value of one-family to four-family residences... neighborhood characteristics, and neighborhood trends are determinants that the appraiser uses in the property valuation process.”*

*Comment: This statement illustrates that analysis of general neighborhood trends and characteristics influences the appraiser’s analysis related to the valuation of the subject property. Therefore, this statement indicates that two analysis should be performed, one to determine the “neighborhood characteristics and trends,” and another when the appraiser is engaged in the “property valuation process.”*

- *Section XI, 403. “Neighborhood characteristics. These can be addressed by the types of structures and architectural styles in the neighborhood (detached, attached, row or townhouse, colonial, ranch, Victorian, etc.); current land use (single-family residential, commercial, industrial, etc.); typical site size (one-eighth acre, two acres, etc.); or street patterns or design (one-way street, cul-de-sac, court, etc.).”*

*Section XI, 403.02. “The degree of development of a neighborhood (which is referred to as “built-up” on the appraisal report forms) is the percentage of the available land in the neighborhood that has been improved.”*

*Section XI, 403.04. “Some of our appraisal report forms provide an area for the appraiser to categorize the predominant occupancy status of the neighborhood—as “owner” or “tenant” and as “vacant (zero to five percent)” or “vacant (over five percent)”—as part of his or her description of the neighborhood.”*

*Section XI, 403.07. “The appraiser should report separately the percentage of developed one-family sites, developed two-family to four-family sites, etc. Undeveloped land should be reported as vacant. In addition, if there is a significant amount of vacant or undeveloped land in the neighborhood, the appraiser should include comments to that effect to ensure that he or she adequately describes the neighborhood.”*

*Comment: These statements indicate that neighborhood characteristics include data that is not specific to properties that compete with the subject. It would therefore be inconsistent for an appraiser to analyze and comment in the Neighborhood section on characteristics as noted above, and then to report one-unit housing and age data that is specific to properties that compete with the subject. To be consistent, the appraiser’s one-unit housing and age data would need to reflect all the types of structures and architectural styles in the neighborhood which are of the same type or category as the subject property (i.e., single family detached).*

- *Section XI, 403. “Generally accepted appraisal standards and our appraisal report forms require the appraiser to research, analyze, and report on the factors in the neighborhood that may affect the market value or marketability of **the properties** in the market area.”*

*Section XI, 403.02. “The appraiser must report on the primary indicators of market condition for **properties** in the subject neighborhood by noting the trend of **property** values (“increasing,” “stable,” or “declining”), the supply of **properties** in the subject neighborhood (“shortage,” “in-balance,” or “over-supply”), and the marketing time for **properties** (“under three months,” “three to six months,” or “over six months”) as of the effective date of the appraisal.”*

*04/2009 Appraisal Guidance. “In general terms, a “declining market” is one in which **home** prices are currently declining.”*

*2002 Handbook for Appraisers. “Your analysis of the neighborhood data must include trends in the supply of and demand for **houses** in the neighborhood... An oversupply of **properties** may be a neighborhood or citywide problem.”*

*Comment: In these and several other statements related to the neighborhood, FNMA references “property(ies),” “houses,” and “home(s).” It is notable that they do not modify the terms by preceding them with the word “comparable.” This is consistent with other statements in the FNMA publications which indicate that the neighborhood analysis is broad and general, and includes an analysis of all homes of the same category (i.e., single family detached).*

- *Section XI, 403. “The results of a neighborhood analysis enable the appraiser not only to identify the factors that influence the value of properties in the market area, but also to define the area from which to select the market data needed to perform a sales comparison analysis.”*

*Comment: This statement indicates that the neighborhood analysis is a separate process which enables the appraiser to subsequently perform the analysis of the subject’s market.*

One of the purposes of the neighborhood analysis is to help establish the conformity, or lack thereof, of the subject property with respect to typical neighborhood characteristics. The FNMA Selling Guide addresses this when it states “*The improvements should generally conform to the neighborhood in terms of age, type, design, and materials used for their construction. If there is market resistance to a property because its improvements are not compatible with the neighborhood or with the requirements of the competitive market... the lender should underwrite the mortgage more carefully and, if appropriate, require more conservative mortgage terms.*” (Section XI, 405.01.)

If an appraiser fails to accurately report neighborhood characteristics, it is not possible to determine with certainty whether or not the subject property conforms to the neighborhood, thereby adversely affecting the lender's risk analysis related to the subject as security for the pending mortgage. Several statements in the FNMA Selling Guides provide evidence of this (**bold** added for emphasis).

- *Section XI, 403.02. "For example, if the typical one-family building site in a particular area (based on the zoning, the highest and best use of the land, and the present land use) is two acres in size, the mortgage will be eligible for purchase or securitization regardless of the percentage of the total appraised value of the property that the site represents—as long as the appraiser demonstrates through the use of comparable sales that **the property is a typical residential property for that particular neighborhood.**"*

*04/2009 Appraisal Guidance. "The lender must review carefully the appraisal report for properties that have **sites larger than those typical for residential properties in the area.**"*

*Comment: These statements indicate that FNMA is interested in determining if the subject property is typical, or conforms, to the neighborhood with regard to site size. This can be properly addressed only when the appraiser accurately reports neighborhood data in the appraisal report.*

- *Section XI, 403.05. "The appraiser must indicate the price range and predominant price of properties in the subject neighborhood. The price range must reflect high and low prevailing prices **for residential properties that are comparable to the property being appraised (one-family properties, two-family to four-family properties, condominium units, or cooperative units)** and, in some cases, for competing properties (one-family properties when the property being appraised is a two-family to four-family property or a condominium unit, or condominium units when the property being appraised is a cooperative unit)... the predominant price will be that which is the most common or most frequently found in the neighborhood... **When the subject property has a sales price (or value) that exceeds the upper price range, the property is considered as an "over-improvement" for the neighborhood. The property is considered as an "under-improvement" if its sales price (or value) is less than the lower price range.**"*

*2002 Handbook for Appraisers. "Report the prevailing high and low prices **for single-family homes** in the area... We consider the predominant price to be the price most frequently found in a neighborhood... If a property has a sales price or value that exceeds the indicated upper range or is less than the indicated lower range, the property may be an over-improvement or an under-improvement for the neighborhood."*

*Comment: These are some of the most direct statements from FNMA as to what they want to see in the Neighborhood section. It is notable that, although they make reference to providing data for properties that are “comparable” to the property being appraised, in this instance “comparable” means homes of the same category; i.e., if the subject property is a one-unit property, then the data should be for all other one-unit properties within the neighborhood (not filtered to include data only for properties that compete with the subject property.)*

*Additionally, these statements illustrate that only the reporting of accurate neighborhood data for all homes of the same comparable category can facilitate the determination of whether or not the subject property conforms to the neighborhood with regard to home values, or if it is an under or over-improvement for the neighborhood.*

- *Section XI, 403.06. “The appraiser must indicate the age range and predominant age of properties in the subject neighborhood. The age range should reflect the oldest and newest ages **for similar types of residential properties** (one-family properties, two-family to four-family properties, condominium units, or cooperative units) and, in some cases, for competing properties (one-family properties when the property being appraised is a two-family to four-family property or a condominium unit, or condominium units when the property being appraised is a cooperative unit.)... The predominant age is the one that is the most common or most frequently found in the neighborhood... **The age of a property should be within the general age range of the neighborhood.** Normally, neighborhoods are developed over a relatively narrow span of time so that most dwelling units will fall within a particular age range. **A property that has an age outside of the general age range must receive special consideration.***

*04/2009 Appraisal Guidance. “The appraisal must indicate the age range and predominant age of **properties** in the subject neighborhood. The age range must reflect the oldest and newest ages **for similar types of residential properties**... The predominant age in the neighborhood is the one that is most common or most frequently found... The age of a property should be within the general age range of the neighborhood... A property that has an age outside of the general age range must receive special consideration.”*

*Comment: These statements illustrate that only the reporting of accurate neighborhood data for all homes of the same comparable category can facilitate the determination of whether or not the subject property falls within the age range for the neighborhood, and therefore conformity with regard to age. As noted, FNMA uses this data in their risk analysis.*

## HUD Handbook 4150.2 (Appraisal Guidelines for FHA-Insured Mortgages)

HUD provides several statements in the Handbook which more directly address the differences between “neighborhood” and “market area” than does FNMA. Several examples are shown below (**bold** added for emphasis).

- *Section 3 - Neighborhood. “This section should reflect **the area surrounding the subject property**. The appraiser must observe neighborhood characteristics **and surrounding properties** to make determinations that will be incorporated into the valuation of the subject property.”*

*“Mark the box describing the current trend in property values for **One-Unit single family homes in the community**.”*

*“To determine the equilibrium status of supply and demand in the neighborhood, compare the number of **houses** sold to the number of **houses** listed for sale in a recent time period.”*

*Neighborhood Description. “Discuss factors that would attract residents or cause them to reject the neighborhood. Some typical factors important to discuss include: level of maintenance and condition of **homes, housing styles, ages, sizes, etc...**”*

*Comment: These statements makes reference to “general” trends, as opposed to trends that are specific to properties that compete with the subject property.*

- *Section 6 – Comparable Data Pool. “The appraiser is required to **report the number of comparable properties** currently offered for sale, as of the effective date of the appraisal, and the number of comparable sales in the subject neighborhood, within 12 months of the effective date of the appraisal, in this section. **Unlike the neighborhood price data, which includes all sales, this section focuses only on those properties that are comparable to the subject, not the universe of sales.**”*

*Comment: This statement draws a clear distinction between what is expected to be reported in the Neighborhood section (data for all sales) with what is to be reported in the Inventory Analysis section above the sales comparison grid (data for properties that are comparable to the subject).*

## 1004MC Market Conditions Addendum

The 1004MC contains the following verbiage that some appraisers have interpreted as meaning that the data on the 1004MC must mirror that in the neighborhood section of the appraisal report:

*“The appraiser must use the information required on this form as the basis for his/her conclusions, and must provide support for those conclusions, regarding housing trends and overall market conditions **as reported in the Neighborhood section of the appraisal report form.**”*

It is of note that HUD has addressed this issue directly with an FAQ which is reproduced below and can be accessed at:

<http://portal.hud.gov/hudportal/documents/huddoc?id=aprval.pdf>

Question: Should data on the 1004MC mirror that in the neighborhood section of the appraisal report?

Answer: Not necessarily, the information on the 1004 MC relates to properties that are comparable to the subject property and which a buyer may select as a competitive property. This reflects the subject's micro market. The information in the neighborhood section is broader and encompasses market activity in the subject's macro market.

Additionally, a review of the relevant portion of the 2010 FNMA Selling Guide provides some guidance on this issue. The section is reproduced below (***bold*** added for emphasis).

B4-1.4-04, Appraisal Report Review: Trend of Neighborhood Property Values, Demand/Supply, and Marketing Time (10/30/2009)

Introduction

This topic contains information on trend of neighborhood property values, demand/supply, and marketing time, including:

- Overview
- Market Conditions Addendum to the Appraisal Report (Form 1004MC)
- Assessment of Market Conditions

Overview

The appraiser must report the ***primary indicators of market condition for properties in the subject neighborhood*** as of the effective date of the appraisal by noting:

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<u>Trend of Property Values</u>	<u>Supply of <b>Properties</b> in the Subject Neighborhood</u>	<u>Marketing Time for <b>Properties</b></u>
<ul style="list-style-type: none"><li>• increasing,</li><li>• stable, or</li><li>• declining.</li></ul>	<ul style="list-style-type: none"><li>• shortage,</li><li>• in-balance, or</li><li>• over-supply.</li></ul>	<ul style="list-style-type: none"><li>• under 3 months,</li><li>• 3 to 6 months, or</li><li>• over 6 months.</li></ul>

**Note:** The appraiser must provide their conclusions for the reasons a market is experiencing declining property values, an over-supply of properties, or marketing times over six months.

**The appraiser's analysis of a property must take into consideration all factors that affect value.** Because Fannie Mae purchases mortgages in all markets, this is particularly important for market areas that are experiencing significant fluctuations in property values **including sub-markets for particular types of housing within the market area.**

*Comment: FNMA's guidance in B4-1.4-04 appears to be inclusive of both the "macro" market when using the terms "property" and "properties," and the "micro" market when referencing "sub-markets for particular types of housing." Since data for the micro sub-market (properties comparable and competing with the subject property) is included in the macro market, it is reasonable to conclude that the one-unit housing price and age grid would reflect data for all sales of homes of the same category as the subject property (i.e., single family detached). To avoid confusion, information specific to the subject's sub-market can be presented in the comment section, or the reader of the report can be directed to the 1004MC Market Conditions Addendum to find that information.*

*The statement that "the appraiser's analysis of a property must take into consideration all factors that affect value," implies that factors outside of the subject's micro sub-market, such as the price and age ranges of the neighborhood, must be considered as part of the analysis, and therefore reported accurately in the Neighborhood section.*

It is also notable that the FNMA statement appearing on the 1004MC references only "housing trends and overall market conditions," not property prices or ages. While it is true that in most cases trends relating to the subject's micro sub-market are similar to the overall neighborhood trends, there are occasions when the sub-market trends are different from the overall neighborhood trends. In those rare instances, the appraiser must not allow the FNMA statement to preclude them from communicating an accurate report. Explanation and support for the appraiser's conclusions of divergent trends for the overall neighborhood and the subject's sub-market should be included in the appraisal report.

## Conclusion

Based on the foregoing, which included information from professional appraisal reference works, FNMA and HUD, it can be concluded that:

- The neighborhood analysis should include data for sales of all homes of the same category as the subject property (i.e., if the subject property is a single family detached home, then all sales of single family detached homes within the neighborhood should be analyzed).
  - The results of this analysis should be reported in the Neighborhood section on page 1 of the URAR.
- The market area analysis includes “filtered” data from the neighborhood which includes sales of properties that are comparable and competing to the subject, and excludes data for properties that are not comparable to the subject.
  - The results of this analysis should be reported in the 1004MC Market Conditions Addendum and in the Inventory Analysis section above the sales comparison grid.
  - Additionally, for clarity, the results of this analysis can be reported in the comments field in the Neighborhood Section on page 1 of the URAR.

Relevant USPAP issues include:

- Proper identification of assignment conditions (acceptable and unacceptable) as part of the Scope Of Work problem identification.
- Knowledge and experience to properly perform the neighborhood analysis and market analysis (Competency).
- Standards Rule 1-1(a), employ recognized methods and techniques to produce a credible appraisal.
- Standards Rule 1-2(e)(a), identify the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including its location and physical, legal, and *economic* attributes.
- Standards Rule 2-1(a), Each written or oral real property appraisal report must clearly and accurately set forth the appraisal in a manner that will not be misleading.
- Standards Rule 2-2(b)(iii), summarize information sufficient to identify the real estate involved in the appraisal, including the physical and *economic* property characteristics relevant to the assignment.
- Standards Rule 2-2(b)(viii), summarize the information analyzed, the appraisal methods and techniques employed, and the reasoning that supports the analyses, opinions, and conclusions.

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