

Uncertainty and Real Estate Foreclosure Sales

Almost everyone has seen an advertisement in a magazine or on television pushing a scheme to get rich in real estate. A typical program encourages the consumer to pay a fee to gain information about how to buy and sell property that has gone into either bankruptcy, foreclosure, or receivership. The “bottom line” is that you can purchase these properties for 20 percent less than their “market value.” It turns out that most homes in foreclosure do indeed sell for approximately 20 percent less than other homes in the area, but this does not mean they sell for 20 percent less than their “market value.”

When a bankruptcy or foreclosure is in place, the seller is no longer the person who took out the loan on the property; the seller is the court system. This increases the level of uncertainty to the buyer regarding when and whether a deal will be consummated, because often there are multiple liens on the property that must first be cleared. This increase in risk reduces the price individuals are willing to pay for the property.

Second, properties sold in foreclosure auctions often represent properties that individuals were unable to sell in the usual real estate market.

Thus, due to adverse selection, the pool of properties sold in foreclosure auctions tend to have characteristics that prevent them from selling in the usual market. Consequently, many of the houses sold in foreclosure auctions have features that are of lower value to buyers than other homes. This also leads to lower prices for the pool of foreclosed houses.

Finally, many foreclosed properties are sold in sealed-bid auctions. In most instances, there is uncertainty about the “true” value of the house, and each potential bidder has his or her own private estimate of the value. In this instance, rational bidders will bid less than their true valuations of the house to avoid the winner’s curse. This also tends to reduce the prices at which foreclosed properties sell.

For all of these reasons, homes that have reached bankruptcy usually are sold at about 20 percent below the prices of other houses in the area. These can be good deals for the person who finds a home in excellent condition. But the uncertainty is greater, which makes purchasing a foreclosed property a riskier prospect.