Why Do So Few People Buy Affordable Properties at Auction?

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February 2022

Distressed sales have declined significantly during the COVID-19 pandemic, reflecting the ease with which homeowners could access forbearance and the presence of the foreclosure moratorium (GAO 2021). This is about to change: the foreclosure moratorium expired in August 2021, and most homeowners remaining in forbearance are expected to exit by early 2022. Most of these borrowers have equity and will opt for a deferral, opt for a modification, or sell the property themselves, but some borrowers do not have sufficient equity to cover the transaction costs of selling plus the deferred principal and interest payments. Many of these properties will be put into the market as distressed sales.

Distressed sales often flow into the auction market. Auction.com launched in 2007, during the early stages of the foreclosure crisis, and has provided a platform for distressed home transactions.[1] The company has since expanded its market share and is now the nation's largest online auction site for foreclosure and bank-owned sales, having sold more than 460,000 properties since it was launched. All states require a public auction for any foreclosed property, and Auction.com accounts for close to 50 percent of these foreclosure auctions nationwide (Auction.com 2021a). If a property does not sell to a third-party buyer at the foreclosure auction, it reverts to the foreclosing lender as real estate owned (REO). Auction.com estimates that 20 to 30 percent of REO properties are sold via online auction, with most of the remainder sold on the multiple listing service. The overwhelming majority of these properties needed substantial renovations, and the properties sold at a fraction of the automated valuation model (AVM) price.

In 2021, the Urban Institute partnered with Auction.com and obtained data on foreclosure and REO sales. Because distressed properties may offer access to very affordable homeownership, we were interested in the share of properties homeowners purchased and whether there are ways to increase that share. We found that most properties are initially sold to mom-and-pop investors, while a smaller share went to owner-occupants who had sufficient cash.

We highlight key findings from the data, focusing on increasing the owner-occupant share.

Auction Sales to Owner-Occupants Are Low but Increase Substantially for Resale Properties

A quarter of Auction.com sales were sold to owner-occupants, with a higher share of foreclosure sales (30.1 percent) than REO sales (20.5 percent) sold directly to owner-occupants, according to public tax assessor data. Nearly all owner-occupant buyers used cash rather than financing for their purchase.[2] On average, REO properties are older and are likely to require more repair, which is a burden for homeowners, especially with a lack of financing options for rehabilitation.[3] Additionally, about half of all REO properties brought to auction during the pandemic were occupied, compared with 45 percent in 2019, before the pandemic. This requires owner-occupant buyers to navigate the current occupant's exit from the property, which can sometimes entail a long and complex eviction proceeding.

About 46 percent of properties sold on the Auction platform from January 2019 to December 2020 were resold by September 2021. The original buyers, overwhelmingly mom-and-pop investors, renovated the properties before resale. Resale rates vary by state: in Arizona, California, and Nevada, more than 65 percent of properties were resold, but in Kansas, Missouri, and West Virginia, less than 20 percent were resold. In general, states that have experienced faster home price growth have a higher resale rate. Additionally, the resale rate is higher for properties sold on Auction in 2019 (49.3 percent) than in 2020 (38.9 percent), which is to be expected, given the time it takes to renovate properties before resale. Owner-occupants purchased 68.8 percent of the resold properties. Again, foreclosure sale properties had a higher share that were resold to owner-occupants (71.3 percent) compared with REO sale properties (65.1 percent) (table 1).

TABLE 1

Share of Sales on Auction.com Sold to Owner-Occupants

Foreclosure versus REO sales

	Foreclosure			REO		
	Not resold	**Resold**	**All**	**Not resold**	**Resold**	**All**
2019	27.7%	71.0%	52.6%	22.0%	67.9%	40.7%
2020	35.5%	69.2%	51.3%	18.3%	58.8%	31.5%
Total	30.1%	71.3%	52.3%	20.5%	65.1%	37.4%

Source: Auction.com.

Note: REO = real estate owned.

Properties in underserved census tracts (low-income or minority census tracts), defined by the Federal Housing Finance Agency, represent 34 to 36 percent of Auction.com sales.[4] We find the share of sales to owner-occupants in low-income or minority neighborhoods does not differ from the overall sample. The net owner-occupancy rate—the share of auction sales that went directly to owner-occupants or were resold to owner-occupants—was 42.0 percent in low-income neighborhoods and 44.3 percent in minority neighborhoods. That compares with a net owner-occupancy rate of 43.6 percent for all census tracts nationwide.

Properties Sold to Owner-Occupants Are Larger and Are Newer Than Those Sold to Investors

Properties sold at auction to both owner-occupants and non-owner-occupants—who are mostly mom-and-pop investors—are substantially older than the median home in the United States (built in 1978) and tend to require considerable repairs. As a result, the distressed sales price is substantially below the AVM price.

“No matter what I’m buying on Auction.com, that thing ain’t pretty,” said one real estate appraiser and investor who owns 11 rental properties in the St. Louis area. “Whenever I fix something, I want it fixed for 20 years.… I’m going to spend a little extra today to avoid a phone call from the tenant tomorrow.”

But even within this universe of foreclosure and REO sales on the Auction.com platform, owner-occupants typically buy newer properties than non-owner-occupants (table 2). They also tend to be larger and have higher distressed sale prices. For example, the average year built was 1971 for the foreclosure properties and was 1965 for REO properties that were bought by owner-occupants through Auction.com, compared with 1967 (foreclosure sales) and 1958 (REO sales) for those that were bought by non-owner-occupants. If property age can be used as a proxy for condition, it indicates that at initial auction, owner-occupants gravitate toward newer properties, which are in better condition.

For the resold properties, there is an eight-year age difference between those that were resold to owner-occupants and those that were resold to non-owner-occupants among the foreclosure properties and a 10-year age difference in the REO sales. Although the distressed sales price is substantially lower for purchased properties than the average market price, the resale price (generally after repair) is similar to the AVM price. This indicates that if some of the properties non-owner-occupants purchase at Auction.com are purchased by owner-occupants, they will likely take on the extensive renovation and potential risks associated with these properties.

TABLE 2

Properties Sold to Owner-Occupants versus Non-Owner-Occupants

	Distressed sale price	Average 2021 AVM	Average resale price	Average year built	Average square footage
Foreclosure sales					
Purchased by owner-occupants	$148,015	$234,800	N/A	1971	1,543
Purchased by non-owner-occupants	$138,130	$225,070	N/A	1967	1,407
Resold to owner-occupants	$169,597	$267,061	$256,369	1979	1,613
Resold to non-owner-occupants	$150,020	$242,496	$241,498	1971	1,455
REO sales					
Purchased by owner-occupants	$143,286	$234,894	N/A	1965	1,737
Purchased by non-owner-occupants	$113,992	$193,419	N/A	1958	1,558
Resold to owner-occupants	$142,962	$235,468	$233,920	1970	1,640
Resold to non-owner-occupants	$127,133	$217,731	$198,308	1960	1,557

Source: Auction.com.

Notes: AVM = automated valuation model; N/A = not applicable; REO = real estate owned.

Financing Is a Barrier for Individual Buyers to Enter This Market

Most states do not structure auction sales to facilitate purchases that require financing. The main barriers to financing are twofold: in a foreclosure sale, potential buyers cannot inspect the properties, which gives lenders a reason not to provide financing. This is also true for REO sales for occupied properties: the current occupant has little incentive to grant access. And because full payment is due at the time of auction in most states, with some states requiring a down payment at the auction with full payment due soon after, there is no opportunity to perform due diligence or to arrange for financing. And once a buyer has won an auction, they cannot back out of the sale, no matter what they find.

Only 4.1 percent of REO properties sold on Auction.com could access a traditional purchase mortgage. This reflects the fact that the property must be appraised, which is difficult if a tenant is in place. Moreover, traditional purchase mortgages are based on the property's "as is" value. Most Auction.com properties are in a condition where a mortgage based on the before-repair property value is going to be insufficient; the necessary rehabilitation is such that a renovation loan is necessary. Of those properties that did not sell at auction, conventional mortgage purchase financing was available only for 1.4 percent. Access to financing does vary considerably by state. Hawaii, Nevada, and Florida all had financing available for a much larger share of properties (27.7, 19.0, and 12.8 percent, respectively) than the national average. And increasing access to financing among auction properties may also increase the share of owner-occupant purchasers; the share of sales to owner-occupants is more than 10 percentage points higher among properties sold with financing (31.8 percent) than those sold without financing (20.2 percent).

Occupied Properties Present a Challenge for Owner-Occupant Buyers

Fifty-two percent of REO properties brought to auction in the third quarter of 2021 were occupied, according to Auction.com data. Owner-occupant buyers, by definition, require the current occupant to leave the property. That often necessitates some type of cash-for-keys arrangement or eviction proceedings—the latter of which can be a long and complicated process that many owner-occupant buyers are not equipped to undertake.

On the other hand, local mom-and-pop investors are typically more knowledgeable about the vagaries of the area's eviction proceedings and better able to accurately budget for eviction or relocation costs. Additionally, these local investor buyers are more willing to allow the current occupant to stay in the property as a tenant. More than 60 percent of Auction.com buyers who hold properties as rentals said they offer to rent back to the current occupant, according to a 2021 buyer survey (Auction.com 2021b).

"We have rented out to a few people that were occupying the property. We'll generally offer it to them at 20 percent under what the normal rent prices are," said one Auction.com buyer in the Chicago area who has purchased occupied REO properties in Cook, DuPage, and Will Counties. "We will maintain the property and we will put [a] new furnace, new air conditioning in. If anything breaks, we'll fix it."

Although this landlord's primary investing strategy is to resell rehabilitated REO homes to owner-occupants, he offers current occupants the option to rent back from him, as it allows him to avoid eviction proceedings, which can take up to a year in Cook County.

Ways to Increase Owner-Occupant Participation in the Distressed Market

Distressed sales could provide a cost-effective way for owner occupants to buy a home. But few distressed homes that trade at auction initially trade to owner-occupants; most trade to mom-and-pop investors. The properties often trade to owner-occupants at resale because distressed properties tend to require major renovations, and most owner-occupants do not have the expertise or inclination to undertake major renovations. And potential owner-occupants who can handle major renovations will find two additional obstacles: financing issues and a lack of access to the properties to estimate repair costs. Neither of these dimensions has an easy solution.

Most of the properties are ineligible for traditional purchase financing, as an appraisal cannot be obtained or because the necessary renovations are too major for a mortgage based on the as-is price. Renovation financing is cumbersome and time consuming to arrange.[5] And even if the property is eligible for traditional purchase financing, the time frame for a mortgage closing is generally longer than the allotted time to pay for the property after auction.

The potential owner-occupant's inability to view the property before the auction is also a major obstacle. Investors often have extensive experience in estimating the breadth and cost of repairs, but owner-occupants generally do not have this experience. Because of these frictions, many distressed sales go to investors. There is no easy solution to these frictions.

But even within the present framework, policy actions could make these properties more accessible to owner-occupants at initial sale. States can make small but valuable changes to the existing foreclosure auction system. Most foreclosure auctions require potential buyers to be physically present at the auction; transferring this process online would make it easier for individuals, including owner-occupants, to attend and would encourage the owner-occupant base to buy. Second, requiring broad marketing of properties before auction would help. These actions could increase the share of owner-occupant purchases at foreclosure auctions.

The experience of Ohio provides insight into the effects of online auctions. Ohio allowed online foreclosure sales beginning in 2017. The Ohio law did not require all foreclosure sales to move online immediately, but plaintiffs in foreclosure cases could request private selling officers, who could conduct online auctions. Of the Ohio foreclosure sales included in the Urban analysis, about two-thirds were conducted online and about one-third were conducted in person at the traditional sheriff's sale. This provides a useful natural experiment to test the impact of online foreclosure sales on owner-occupancy rates. In Ohio since 2019, 47 percent were online foreclosure sales and 33 percent of traditional, in-person sales sold directly to owner-occupants.

In addition, one could envision a first-look REO auction for properties that do not sell at foreclosure auction. The first-look auction would give owner-occupants—along with mission-driven nonprofits and mom-and-pop investors who agree to provide high-quality affordable housing for low- and moderate-income families—the ability to bid on a home before it is available to other potential bidders. Nonprofits and mom-and-pop investors would go through a certification process to qualify as local community developers who can bid during the first-look auction. This would likely increase the share of homes owner-occupants could purchase directly, or indirectly through a nonprofit or local community developer. Ideally, a first-look program would give these buyers a 30-day exclusive period to bid on properties before those properties are made available to other buyers. Although a first-look auction may not be helpful for all distressed properties, Jakabovics and Sanchez (2021) have shown that first-look policies result in higher owner-occupancy rates, particularly in low-income minority census tracts. If the property does not sell at the first-look REO auction, the seller could allow the property to be included in a broader auction or sell through other channels.

Notes

[1] See https://www.auction.com/.

[2] These were properties categorized as owner-occupied in county assessor data as of September 2021 that had no subsequent arms-length sale found in the county recorder or multiple listing service data following the sale on Auction.com.

[3] Laurie Goodman and Edward Golding, "Institutional Investors Have a Comparative Advantage in Purchasing Homes That Need Repair," *Urban Wire* (blog), Urban Institute, October 20, 2021, https://www.urban.org/urban-wire/institutional-investors-have-comparative-advantage-purchasing-homes-need-repair.

[4] "Underserved Areas Data," Federal Housing Finance Agency, accessed February 1, 2022, https://www.fhfa.gov/DataTools/Downloads/Pages/Underserved-Areas-Data.aspx.

[5] Goodman and Golding, "Institutional Investors Have a Comparative Advantage."

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Acknowledgments

The Housing Finance Policy Center (HFPC) was launched with generous support at the leadership level from the Citi Foundation and John D. and Catherine T. MacArthur Foundation. Additional support was provided by The Ford Foundation and The Open Society Foundations.

Ongoing support for HFPC is also provided by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. Funds raised through the Forum provide flexible resources, allowing HFPC to anticipate and respond to emerging policy issues with timely analysis. This funding supports HFPC's research, outreach and engagement, and general operating activities.

This brief was funded by these combined sources. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

The data for this report were obtained from Auction.com. We are grateful for the data sharing, which enabled us to conduct evidence-based research, the core mission of the Urban Institute.

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