

# The Home Appraisal Process

A home appraisal is an evaluation and report performed by a licensed appraiser to determine a home's fair market value. Lenders require a home appraisal to ensure the amount you agreed to pay for the home is equal to or less than the appraised value.

A home appraisal is important for you and the lender. Most home buyers don't want to invest more in a home than it's worth. You'd have negative equity right away and it would take much longer to earn positive equity. Lenders require an appraisal to ensure the collateral (the home) is high enough should the borrower default on the loan.

In today's hot market, many prospective buyers will get into bidding wars and possibly waive the appraisal contingency or offer an appraisal guarantee up to a certain amount.

In both cases, the buyer would have to come up with the difference in cash between the appraisal and the sale price, or their appraisal guarantee and the sale price.

Appraisers evaluate the home looking at the following factors:

- **Home's condition:** Appraisers evaluate a home's safety, sanitation, and soundness. They'll count the number of bedrooms and bathrooms. Make sure the home is livable, that all systems are functioning, and that there aren't any major issues with the home.
- **Comparable sales:** Appraisers compare the home to the comparable homes in the area that sold within the last 6 months (sometimes longer). They look for homes with similar structures and features to determine the subject property's fair market value. This also gives buyers a chance to see how close the asking price is to the fair market value.

## Why is this important for you?

The difference between your home's appraisal amount versus loan amount can determine how much money you're allowed to borrow. For example, if you bid \$400,000 for a home, but the Appraiser determines that based on recent home sales that are of similar size, location & condition, that the home's value is just \$390,000, then lenders will base your loan amount off the \$390,000 value.

## What Is An Appraisal Gap?

An appraisal gap is the difference between the fair market value determined by the appraiser and the amount you agreed to pay for the home. An appraisal gap doesn't mean you have to cancel the sale, but it may mean you have to negotiate with the seller or pay the difference for the home out of pocket.

Some sellers require what's called an appraisal guarantee clause. This is common in a seller's market when there are more sellers than buyers and sellers can call the shots. The appraisal guarantee clause states you'll make up the difference if the appraisal is lower than the accepted offer. The difference needs to be covered and, in this case, it would be the buyer's responsibility.

**That's not your only choice, though...**

# What Should You Do When the Appraisal Is Less Than Your Accepted Offer?

You have several options when the appraisal is less than the offer including walking away from the sale, but that doesn't work in every situation. Here's what to consider.

## Pay The Difference

If the seller won't negotiate the price lower, you'll be on the hook to pay the difference unless you have an appraisal contingency in your contract. The appraisal contingency gives you a way out of the contract without losing your earnest money. Without it, you must buy the home or risk losing your earnest money.

**Without a lower sales price, you'll have to pay more for the home in some way.** Since lenders base your loan amount on the appraised value, you'll need your agreed-upon down payment plus the difference between the sales price and appraised value.

What if you don't have the cash? Ask for gift letters from family members or leverage your investments. You may be able to use some retirement funds without paying a penalty. Talk to your 401(k) administrator or tax advisor to see what options you have. If you own other real estate, consider tapping into the equity and using the funds to cover the appraisal gap.

## Renegotiate The Offer

If you have an appraisal contingency on your sales contract, you may be able to work with the seller. Start by requesting the seller to lower the price to the appraised value.

This would eliminate the appraisal gap and your financial issues in buying the home.

If the seller is unwilling to lower the price to meet the appraised value, ask them to split the difference. For example, if there's a \$10,000 difference, ask the seller to lower the price \$5,000 and you contribute the other \$5,000.

Asking the seller to renegotiate can be risky in a seller's market, so be careful. If the seller has a kick out clause, they could accept another offer that comes through. They still must give you the time to remove your appraisal contingency and seal the deal, but they can choose the other offer if you don't.

## Dispute The Appraisal

Sometimes buyers (or sellers) don't agree with the appraisal. In this case, you can dispute the appraisal, asking for a reconsideration of value. However, this is not easy to do as you'll need plenty of evidence to prove the appraisal is inaccurate.

You must prove one of the following:

- The appraiser didn't use appropriate comparable sales, and you have proof of more accurate options
- The appraiser missed features or upgrades in the subject property
- You found mistakes in the report
- The appraiser only conducted a drive-by or exterior appraisal

To dispute the appraisal, you must do it in writing. Carefully write a detailed letter stating why you are disputing the appraisal and your proof to back up your claim. Keep your letter short, polite, and to the point and supplement it with as much evidence or research as possible.

## **Walk Away from the Sale**

It's not the most pleasant choice, but if you're worried about paying more than a property is worth, sometimes walking away from the sale is the best option. If you've unsuccessfully renegotiated with the seller and disputed the appraisal to no avail, it may be best to look for another property.

Before you do this, talk to your attorney. If you didn't include an appraisal contingency in your contract, you might risk your earnest money. Sometimes other contingencies still help, though, especially a mortgage financing contingency.

## **Appraisal Gap Coverage Vs. Appraisal Contingency**

When you're buying a home, you'll likely hear two words thrown around before you sign the contract - appraisal gap coverage and appraisal contingency. They sound similar but have different meanings.

Appraisal gap coverage isn't an insurance policy, even though it sounds like one. Instead, it's wording in the contract that binds you to buy the home even if the appraisal comes in lower. Pay attention to this area of the contract and either ask for it to be removed or put a cap on how much you're willing to pay to cover an appraisal gap.

An appraisal contingency gives you a legal way out of the contract if the appraised value doesn't match your agreed-upon sales price. The contingency allows you to back out of the contract and keep your earnest money. If you backed out of the contract without the contingency, the seller could keep your earnest money, which could be between 1%-3% of the sales price.

## **When Is an Appraisal Gap Coverage Clause Necessary?**

While no one wants to pay more than a home is worth, in a competitive seller's market, it may be necessary. If you want your bid to outshine the others, an appraisal gap coverage clause may be necessary. The clause states how much of an appraisal gap you're willing to cover. Since there's no guarantee an appraisal will match the agreed-upon sales price, it's often something sellers look for to know the offer will still stand even if the appraisal comes in a little low.

In the appraisal gap coverage clause, you and the seller must agree on how much you're willing to pay above the appraised value and if you want the difference split. Agree on as much as possible, putting it in writing before signing the contract to prevent stress and unnecessary renegotiations after the appraisal.

## **The Bottom Line**

It's never pleasant to hear that you have an appraisal gap after signing a sales contract, but it's often a reality in today's fast-paced real estate market.

It's essential to protect yourself going into the contract and to have a plan on how to proceed should the appraisal come in lower. Buyers have many options, but you must choose the one that's most comfortable for you.

If you're ready to start your home buying process and would like a professional to help you through every step of the way, learn how to get started.