How to protect your buyers from appraisal catastrophes

With multiple offers being the order of the day, buyers are overbidding to outgun their competitors. What happens if an appraisal comes back low? Here are a few important steps to take before writing an over-asking offer

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BY CARL MEDFORD
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This month, we'll talk to mortgage leaders about where the market is headed and how products are evolving digitally to suit buyers' needs now. We'll also explore emerging alternative financing options that are changing the game for buyers and sellers. Join us for Mortgage and Alternative Financing Month.

I had a disturbing call recently. We put one of our listings into contract with a buyer who had submitted a fully non-contingent offer $100,000 over list price.

That is not unusual in our market. In this current overheated madness, a significant percentage of offers are written non-contingent, and we can easily see homes go a few hundred thousand dollars over realistically set asking prices.

The call was from the buyer's agent, who cut right to the chase. "I just talked to my lender," the agent said. "She let me know that if the property only appraises at list price, our deal will not work. They don't have enough to make up the difference."

"I'm sorry to hear that," I replied, "but I'm not sure what you want me to do — we are in a binding non-contingent offer."

Their response? "We did not discuss our offer with the lender before writing." *Bad* move.

No matter who you talk to anywhere in the country, inventory is at unprecedented lows. The result is buyers scrambling to find homes and fighting tooth-and-nail to get a contract accepted on one of the few properties available.

In this unprecedented environment with multiple offers on almost every listing, buyers will do almost anything to land a contract. A prevalent tactic in our market is to submit offers with all contingencies removed.

Most sellers in our region, priming the pump for non-contingent offers, provide full disclosures and inspection reports upfront, and as a result, many buyers feel comfortable removing their inspection contingency. Additionally, with lenders going to extra lengths to preapprove their buyers, many homeowner wannabes do not hesitate in removing loan contingencies as well.

The real rub comes with the appraisal contingency for properties on which a buyer needs to procure a loan. Even with properties that are priced correctlybased on past closed sales, it is not uncommon to see multiple offers driving offer prices to dramatic new heights.

In many cases, the offered prices are significantly above comparable sales, which in turn makes the requisite appraiser's task incredibly difficult. While some appraisers understand the increasing market and try to justify soaring prices, others are not comfortable with the new reality and provide valuations more in line with previous sales.

This difference in appraisal styles adds confusion to the market and increases the difficulty for buyers determining how high they might go for any given property. As an example, if a property is listed at $500,000 but buyers offer $600,000, they are $100,000 over the asking price.

If they have an 80 percent loan approval and are putting 20 percent down, their loan will be $480,000 with a down payment of $120,000. If the property appraises at $500,000, then the lender will only provide 80 percent of the appraised value: $400,000. This means that a buyer needs to be able to provide a down payment of $200,000 to make the deal work.

If the buyers have the extra cash, the deal can proceed. If, eager to score a deal, they write a non-contingent offer and do *not* have the extra cash, the deal may collapse, and they could forfeit their deposit. These are tough times indeed, and it once again underscores the age-old saying, “Buyer beware.”

As real estate agents, our job is to look out for the best interests of our clients. With this in mind, here are three steps we take before writing an over-asking price offer:

1. Compile a comprehensive picture of a buyer’s true financial capabilities

In addition to a preapproval, we ask for verification of funds on deposit that can be liquid within 30 days. We are sometimes shown fund balances that are in long-term CDs, retirement vehicles or other funds that cannot be readily accessed — these cannot be used.

We also check to see if funds are available from family members, friends and the like. If they are, we gather the details and make sure we have gift letters. With the preapproval and fund totals in hand, we can then set a limit on the buyer’s capabilities.

2. Run a comprehensive comparative market analysis (CMA) to determine a fair market value for any home they wish to purchase

We have discovered that in the heat of the battle, many buyer’s agents fail to determine a fair market value for a listing and, therefore, have no idea what a realistic offer might actually be.

Even though we will most often be offering more than the list price, we run the CMA because we have to know what valuation an appraiser might end up with. The actual market value provides the foundation upon which we base the calculations needed to determine how high a buyer can actually go over list price.

3. Plug the numbers into an appraisal calculator

We start with the following:

- Offer price.
- Percentage of loan to purchase price.
- Loan amount.
- Down payment amount.
- Projected closing costs.

By adding the closing costs to the offer price and subtracting the loan amount, we end up with the amount of cash required to close. If an offer is being made for $600,000 with an 80 percent loan and $10,000 in closing costs, we will need $130,000 to close the transaction if the property appraises at $600,000.

We then factor in the following:

- The price at which we believe the home might actually appraise (taken from the CMA).
- The new loan amount based on the projected appraisal price.
- The desired offer price minus the new loan amount.

Appraisal Calculator	
Offer Price	**$600,000.00**
% Initial Good Faith Deposit	3.00%
Good Faith Deposit	$18,000.00
% Increased Good Faith Deposit	0.00%
Increased GF Deposit	$0.00
Total GF Deposit	**$18,000.00**
Total % Deposit	3.00%
% Loan to Purchase Price	80.00%
Loan Amount	**$480,000.00**
% Down Payment	20.00%
Total Down Payment	**$120,000.00**
% Credit for Closing Costs	0.00%
Closing Costs Credit Amount	$0.00
Net to Seller	**$600,000.00**
Estimated Appraisal Value	$500,000.00
Closing Costs %	1.60%
Closing Costs Amount	**$9,600.00**
Cash Required to Close	**$229,600.00**
Actual Funds on Deposit	$240,000.00
Balance of Funds Remaining	$10,400.00
Max Price You Can Offer	**$610,400.00**

As an example, if your offer is $600,000, but you believe it will appraise for $500,000, and your loan-to-purchase ratio is 80 percent, then the lender will only lend 80 percent of the actual appraised value, which results in a loan amount of $400,000.

If your offer is $600,000, but the lender will only lend $400,000, then you add the projected closing costs to the offer price and subtract the revised loan number ($600,000 plus $10,000 for a total of $610,000 minus $400,000 for a balance of $210,000).

In this scenario, if the home appraises at $500,000, but the contract price is $600,000, instead of needing $130,000, the buyer must bring in a total of $210,000 to make the deal work.

Once we have run this calculation, we go back to the buyer's available cash — if they have in excess of the amount required if it appraises low, we know we can remove the appraisal contingency. If they are short, then it is a no-go.

Because these calculations can be a bit clunky, we built an excel spreadsheet that quickly does the calculations for us. It takes about 20 seconds to plug in the numbers. We even set it up so it gives us the maximum amount they could offer based on the amount of cash on hand.

At the end of the day, the goal is to get a property for the buyer and protect them at the same time. The worst thing that can happen is getting into contract and then discovering that your clients do not have what is needed to actually get it closed.

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