

# Beware of The Appraisal Gap

Getting a low valuation on a home appraisal feels a lot like getting ripped off. If your home appraisal comes in lower than the purchase price, your lender will likely decrease the amount of money you can borrow. This leaves homebuyers to either pay more out of pocket or request the seller to lower the asking price.

This used to be a rare occurrence, but in recent months, it's been happening more frequently and at greater levels than ever before. Chief appraiser for CoreLogic, Shawn Telford said, "Recently, we observed buyers paying prices above listing price and higher than the market data available to appraisers can support. This difference is known as the appraisal gap."

When you read about today's housing market, the press will often describe it as being "red hot" or "white hot" or any kind of hot there is, because houses are selling like crazy. The news is all about bidding wars, homes selling in a matter of hours, inventory at desperately low levels, and prices soaring so high, they'll make your eyes water. There are a lot of contributing factors to the rapid price appreciation we're seeing today, including low interest rates and the shift to remote work, but at the end of the day we can all understand that low inventory and high demand equals ultra high prices.

Beginning in January 2020, 7% of purchase transactions nationwide had a contract price above the appraisal valuation. In May, the frequency increased to 19% of purchase transactions, and the frequency of having an appraisal over contract price from 69% in January to 52% a year later. Yet, the frequency of appraised values matching contract sale prices remained relatively flat, moving from 24% to 29%.

Homebuyers can also be negatively impacted if the appraised value is more than the contract price because the lender will use the lower of two values to calculate the loan-to-value (LTV) ratio. This scenario also requires the borrower to pay out of pocket to close the gap or purchase mortgage insurance because their LTV is higher than planned. Worst case scenario is the sale falls through because the anticipated financing did not work out.

As these appraisal gaps started to widen, the CoreLogic Home Price Index (HPI) began a steady climb as well. The HPI moved from 4% annual growth in January 2020 to 15% through May 2021. Comparing HPI data and appraisal gap data side by side reveals that these trends are on the same trajectory. There are several potential explanations for this.

Appraisers rely on the most recent sales data to base their opinion of value. Basically, they look at similar homes to see what they're valued at. But the most recent — transactional sales data — can lag. For example, a sales price is negotiated for two months before closing; meanwhile, the prices offered by buyers continue to increase. This impacts the ability of appraisers to account or adjust for current market conditions when the market is rapidly changing.

What makes matters even more complicated is how buyers behave in a fast-moving market. More of them are willing to pay a premium price for the homebuying, mortgage, and appraisal process. When buyers feel the unusual pressure of a shortage, they appear more than willing to pay a premium to get a home.

According to the CoreLogic HPI forecast, home price growth is expected to moderate within the next year. Specifically, the U.S. Home Price Index is supposed to rise 3.4% from May 2021 to May 2022, as the balance between supply and demand returns to normal. This will also help reduce the amount of appraisal gaps, reverting them back to a rate of 7% to 9%.