

What Is Earnest Money and How Much Should You Pay?

When you jump into a real estate deal, a lot of money goes on the line. On top of figuring out whether you're an actual buyer, sellers have to remove properties from the market, which can eat into their take-home profits.

To protect themselves financially, home sellers sometimes ask for earnest money deposits. Read on for information about what earnest money is, why it's important and how much you should expect to pay.

Earnest money explained

Put simply, earnest money is a deposit made before closing on a house purchase. In essence, earnest money works as a way of showing that a homebuyer is serious about buying the house and isn't just trying to cut out any competition/competing bids.

Also called a good faith deposit, an earnest money deposit is often required or requested by a home seller if they are expected to take a house off a competitive market.

When this happens, the seller doesn't look at any other bids or offers from other potential buyers. Furthermore, the seller may pay specific preliminary fees to move the transaction closer to the closing part of the process.

Think of an earnest money deposit as a good faithdown payment to show a home seller that you are serious about buying their property. With an earnest money deposit, you can convince a home seller to take their property off the market, thus eliminating the risk that someone may bid more than you for

the same property.

In exchange, you get your earnest money deposit “back” (or put toward the purchase of the property) if the deal falls through for some reason. Because of this, an earnest money deposit is a very safe investment for a prospective homebuyer.

Earnest money vs. down payment

While they are similar, earnest money deposits are not the same as a home down payment. A down payment is the total amount of a home’s purchase price that you pay before you finance the remaining price with a mortgage loan.

Most people make down payments for residential properties of between 10% and 20% of the purchase prices (at least if they pursue 15-year fixed-rate mortgages). First-time homebuyers may pay as little as 3% to 5%.

An earnest money deposit does not go toward the purchase price or down payment for a new home, at least at first. It’s just insurance money that the home seller can take home if you breach the terms of an agreement.

If you don’t reach any terms and the deal goes through smoothly, the earnest money deposit can go back into your pocket or be put toward your home’s down payment or closing costs, depending on your preferences.

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Why is earnest money important?

In a nutshell, earnest money is essential because it eliminates some risks of removing a property from a house listing service/platform for a home seller.

When sellers remove their property from the market, they can’t get new bids or offers from other prospective buyers. They may

also have to pay various fees.

If the deal falls through for whatever reason, the seller suffers more than the buyer; they have to put the property back on the market, update marketing materials and pay additional fees.

With earnest money, the seller knows the buyer is serious and has a bit of financial cushion. If the buyer breaches the conditions of a homebuying contract in some way, the seller may be able to keep the earnest money deposit to compensate them for lost time and potentially lost profits.

Do you always have to pay earnest money?

No, but it's always a good idea to be prepared to do so. Earnest money is not always required, but it could be more common than not if you are looking to buy a house in a competitive real estate market.

That's because competitive real estate markets usually have more power in the sellers' hands than the buyers. Due to this, you may find yourself competing with many other buyers over the same property.

Furthermore, many experienced home sellers require earnest money deposits no matter what because it operates as extra insurance for both parties in a given property transaction.

Plus, as a homebuyer, an earnest money deposit is usually good if you can afford it. In most cases, you can put the earnest money toward the down payment or closing costs for a real estate transaction, so it's not really "extra" money you have to pay overall. It may be a small amount of extra money you need to pay upfront.

In addition, offering a good faith deposit can help convince a home seller to choose your offer compared to others.

For example, if you offer \$500,000 to purchase a new property plus an earnest money deposit, but another person offers \$502,000 to buy the same property, the seller may still go with your offer since the good faith deposit proves you are committed to the purchase.

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How much earnest money should you pay when buying a house?

The amount of earnest money you may pay varies heavily based on market conditions, property conditions and other factors. That said, most good faith real estate deposits are between 1% and 3% of a property's overall purchase price. For instance, if a property is \$500,000, you can expect to pay between \$5000 and \$15,000 in your good faith deposit.

However, you'll need to talk to the home seller to determine how much they want as a good faith deposit before they agree to enter deeper negotiations to purchase their property. Good faith deposits can be as high as 10% of the home's asking price in the most competitive properties. A lender might have you base the good faith money on something other than the home sale price.

Alternatively, you may find that some sellers prefer fixed earnest money amounts to filter out buyers who aren't serious about purchasing the property.

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How do you make an earnest money

deposit?

There are many ways to make an earnest money deposit, but most home buyers and sellers rely on a trusted, straightforward process that minimizes risk on behalf of both parties.

Write down the earnest money details in the homebuying contract.

To start, write down all the details for the earnest money or good faith deposit in the homebuying contract. Your real estate agent (and the home seller agent) should help you draw up these terms and conditions to minimize any loopholes and ensure that all parties understand their rights and responsibilities.

Specifically, you need to make sure that your contract defines what counts as “canceling” or “voiding” the sale, which may result in you having to pay your earnest money to the home seller even if you can’t go through with the purchase.

Your contract should include relevant amendments, such as buyer timelines and responsibilities.

Make sure it includes a home inspection contingency, an appraisal contingency and a financing contingency, so your earnest deposit is returned if the seller doesn’t do their part. The last contingency requires aspiring homeowners to get a home loan before a deadline.

Have your agent explain all of this to you so you fully grasp what you need to do (and when you need to do it) so you avoid wasting your good faith deposit money.

Use an escrow account.

Next, never give your good faith deposit money directly to a real estate broker, agent or even the home seller personally.

Instead, you should rely on a reputable, trustworthy third party like an escrow company or title company.

Using an escrow account means putting the earnest money deposit into a third-party, neutral account, where it sits and will be released when certain conditions are met.

Note that you'll likely use an escrow account for your down payment and other money when buying a house, so it's usually trivial to include an escrow account for the good faith deposit. Sometimes, you can even use the same escrow account for all your real estate funds transfers.

Meet any responsibilities.

Now all you have to do is meet your responsibilities as a homebuyer. Most real estate purchase agreements set deadlines to protect sellers and let them put their properties back on the market if a certain amount of time elapses.

Respond to all the questions the seller poses and promptly provide any required documents to the seller, such as proof of ID and insurance.

You'll also want to ensure whether the property needs any appraisal, inspection and closing deadlines. This can help the seller avoid breaching the contract by accident, which can cause confusion regarding earnest money and who gets what.

If all goes smoothly, your earnest money deposit can cover part of the closing costs for the home purchase or be folded into the down payment amount transferred to the home seller when the real estate transaction goes through.

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Is earnest money refundable?

Generally, you will get earnest money back, provided everything goes how it should during the homebuying process. If you fulfill your terms in a property purchase contract, earnest money will get folded into the closing costs or down payment amounts for the home.

Your agent should write and review your sale contract to ensure an earnest money refund if something goes awry.

For example, if you make an offer for a home, but it gets appraised for a lower price, ensure your contract still stipulates that you get your earnest money deposit back. The same goes for ordering a home inspection or when you can't get financing.

Most real estate purchase contracts have deadlines or requirements for both buyers and sellers. You may not get your earnest money refunded if you breach one of the terms of the contract, such as providing down payment money by a specific date.

In that example, not providing your down payment money by the deadline could show the seller that you aren't serious about purchasing the house, causing them to take the earnest money deposit as compensation.

When do you lose earnest money?

In other cases, you must be prepared to lose your earnest money deposit. Things happen, even when you intend to go through with a real estate deal.

For instance, you may experience an accident or lose your job, preventing you from purchasing the house. While you should try to avoid it, you may just have a change of heart and decide to stay in your current home.

In such cases, the odds are that the seller will get to keep your earnest money. After all, that's the point of the good faith deposit: compensating the seller if they spend time on you as a buyer, only for the deal to fall through.

Of course, this isn't always the case. In some cases, if you speak to a home seller and explain your situation, they may be willing to refund your earnest money deposit. But don't expect this kind of behavior in a market as competitive as real estate.

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How much earnest money should you expect to pay?

Earnest money is an initial, good-faith deposit that financially protects home sellers if a home buyer backs out of a deal.

Earnest money is usually between 1% and 3% of a property's purchase price. Expect to pay earnest money in many homebuying scenarios.

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