What is a Loan-to-Value Ratio?

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When shopping for a mortgage, one term you are likely to hear is a "loan-to-value ratio," also known as an LTV.

What is a loan-to-value ratio?

The LTV is the loan amount expressed as a percent of either the purchase price or the appraised value of the property. It is an important factor considered by lenders before approving a mortgage, and one of the key risk factors that lenders assess when qualifying borrowers.

For instance, if a borrower borrows $130,000 to purchase a house worth $150,000 at a relative valuation, the LTV ratio is $130,000/$150,000 or 87%.

The risk of default is always at the forefront of lending decisions, and the likelihood of a lender absorbing a loss in the foreclosure process increases as the amount of equity decreases. Therefore, as the LTV ratio of a loan increases, the qualification guidelines for certain mortgage programs become much more strict. Lenders can require borrowers of high LTV loans to buy mortgage insurance to protect the lender from the buyer default, which increases the costs of the mortgage.

LTV ratios below 80 percent carry with them lower rates for lower-risk borrowers, and allow lenders to consider higher-risk borrowers. What makes a buyer high risk? It's a negative credit history, as well as high debt-to-income ratios and insufficient income documentation. Higher LTV ratios (above 80 percent) are typically reserved for borrowers with higher credit scores and a clean mortgage history.

Buying private mortgage insurance, which insures the lender against default, can reduce the LTV to 90 or 95 percent, making it possible to have a down payment of 10 or 5 percent.