



Why should I care about LTV and FMV?

A: When you apply for a mortgage and consider your down payment options, you will come across two important terms:

- loan-to-value ratio (LTV); and
- fair market value (FMV).

Your **LTV** states the mortgage amount as a percentage of the property's purchase price or FMV. The **FMV** is the price a reasonable, unpressured and informed buyer is willing to pay for similar property on the open market.

For example, consider the owner of a home with an FMV of \$500,000. They owe \$400,000 on their mortgage. Therefore, their LTV is 80% ($\$400,000 / \$500,000$).

Sometimes, a homeowner will owe more on their mortgage than their home's current FMV. This is especially common during a recession, a period when prices drop.

For instance, the owner of a home with an FMV of \$500,000 who owes \$600,000 on their mortgage has an LTV of 120% ($\$600,000 / \$500,000$). In this situation, the homeowner is **underwater** on their mortgage, their balance sheet now financially saddled with \$100,000 in **negative equity**.

When an underwater homeowner needs to sell their home, they may either:

- take a loss on the sale by paying off the balance of their mortgage using "out-of-pocket" funds such as savings, if financially feasible; or
- under extenuating circumstances, negotiate a short sale with the lender, during which the lender accepts the net proceeds of the home sale in exchange for cancelling the unpaid mortgage balance.

Homeowners with effective negative equity are those who have an LTV just below 100% but, due to the lack of positive net equity, are unable to cover **transaction costs**, typically 7% of the home's value.

The smaller the down payment a homebuyer makes, the more likely they are to slip into negative equity territory since home values often fluctuate. Further, when an appraisal comes in below the agreed-to selling price, the lender will approve the mortgage based on the appraised value — the property's FMV — and require the buyer put in the difference between the sales price and the FMV. As an alternative, the sales price reduced its appraised value through negotiations with the seller. A homebuyer who overpays and makes a small down payment will likely be underwater immediately.