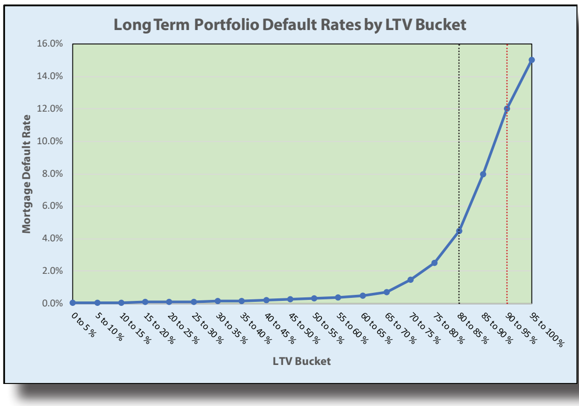
Global Housing Strategies
consulting & investment services

The Problem with High LTV Lending

The underwriting and closing of good mortgage loans relies on evaluation of the loan-to-value (LTV) ratio. LTV is a measurement of the amount of equity, or "skin-in-the-game," that a homeowner has in his new home. This ratio is extremely valuable in underwriting a mortgage loan because It is a very good predictor of the likelihood of default of the loan over its life. The ratio is obtained by calculating the mortgage loan amount in relation to the "value" of the home as measured by the lower of appraised value or sales price.

"High" LTV is a relative term. However, many experienced lenders recognize an inflection point at the 80 percent level. The adjacent graph, taken from mountains of performance data in many different markets, bears this out as we clearly see the asymptotic rise of the default curve near the 80 percent LTV point. If you want to avoid high default rates, then restrict lending below the 80 percent level.



Other loan performance factors can influence – and modify – this well-established rule. For example, a household with a high credit score, proven performance history during periods of financial stress, collateral property is occupied by the borrowers and is their primary residence, and the quality of loan documentation all are factors that can potentially push the 80 percent threshold to 85 percent or even 90 percent. The underwriter's concern is the likelihood or probability of default which is the vertical axis in the adjoining graph and reveals devastating levels of default at greater than 90 LTV. In addition, the default probability does not say anything about the projected loss ratio, and this ratio can center around 35 percent or more of the value of the home. Mortgage lenders want to avoid default situations because they can be harmful to a mortgage lending operation even beyond the simple capital losses that typically occur in trying to resolve the default. A non-performing loan does not generate interest income for a three to six-month period in the best of cases, and the cost of "special servicing" can be very draining to a lender.

Why 80 percent? The best answer to this question is that the great mass of loan performance data bears it out. The shape of this curve is the same whether the lending took place many years ago or in the recent past, whether the originations took place in emerging or developed markets, whether the borrower is young or in the work force for several years.

Banking regulators, especially in emerging markets, are sometimes tempted to relax the "80 percent rule" and permit high LTV mortgage lending even up to the 100 percent level. When asked to explain their rationale, especially against the evidence of broad-based loan performance histories, the answer often given is that national policy objectives require loosening of traditional rules to enable economically marginal and worthy households to become homeowners and obtain the security of homeownership, admittedly an important social and economic goal. Our view is that potential homeowners are never helped in the long run when overall loan performance deteriorates to very low levels. It can put the entire banking system at risk, which does not help anyone.

Finally, it is useful to keep in mind the worldwide mortgage crisis that erupted in 2008 but was perhaps ten years or more in the making. Any analysis of the roots of that crisis will list many factors and excesses, but chief among them was poor loan documentation coupled with high LTV lending driven by a rush to [obsession with] homeownership. Alternative housing solutions exist and should be offered to households with inadequate credit histories, or shortfall in required down payment. Homeownership is not for everyone, but, when suitable, must be implemented in its proper time guided by prudent underwriting.

Other ideas? (a) a credit guarantee fund for LTV's in the 80 to 90 percent bracket; (b) a private mortgage insurance scheme for LTV's in the 80 to 90 percent bracket; (c) permit, for example, 10 percent of any portfolio to hold loans with LTV's in the 80 to 90 percent bracket, none above 90 percent, provided those loans have credit risk protection and/or mitigating factors such as borrowers with high credit scores.