Why the Qualified Mortgage Rules Are Wired Wrong

By Dave Porter, PorterWorks, November 2015

Dodd-Frank. Just the names bring panic and fear to lenders across the country. There have been an amazing amount of changes to mortgage lending and certainly the introduction of some important standards for methods lenders should use. Let's take a look at the newer component of the bill: "QM" or "Qualified Mortgage." A QM mortgage must meet new guidelines. Borrowers who meet these tighter standards are presumed to have satisfied the "ATR" or "Ability to Repay" the mortgage debt. Lenders want to make QM loans because lenders then have more protection against future lawsuits if the loan goes sideways.

Basic criteria to be classified as a QM is that the loan term can be no longer than 30 years (for most lenders this is not an issue; only a few lenders were active with offering 40 year term loans). Another feature is the elimination of interest only payments or payments that do not cover the full amount of interest (negative amortization). Other safeguards include no more than 3% in upfront fees or discount points. A 1% loan fee is common among lenders and additional points or fees may reduce the rate. The 3% limitation will not allow buyers to pay higher points upfront in exchange for a long term lower interest rate.

But this article addresses the last regulation for a QM, which is the 43% debt ratio calculation. The debt ratio is a percentage of your consistent, verifiable gross income that is allocated for your house payment (what is referred to as "PITI" or principal, interest, taxes and insurances). So if you have too many credit cards, too many student loans, too much alimony or child support or car loans for example then you may not qualify.

The safeguard idea in itself is not necessarily incorrect; the blind spot is in how it actually is employed. Unfortunately this "blind spot" of underwriting a borrower's ability to repay a mortgage debt has been unaddressed since the creation of the secondary market and underwriting mortgage debt.

Let's go back to the house payment, the PITI. So is this *really* the house payment? What about costs to maintain the home? What about consumers costs to commute from home to work and back again? And, what about the costs to provide utilities to that home? Not all $400,000 homes are created equal. A home built in 2014, adhering to the new stringent energy codes (or a home that exceeds the codes and is built green and energy efficient) boasts significant energy savings over, say, a home that was constructed in 1965 that may not even have insulation at all. Utility costs matter. According to a study completed by the Institute for Market Transformation (IMT), an average American homeowner might pay $1,897 in real estate taxes and $822 in fire or hazard insurance (both of which are accounted for when qualifying for a home mortgage) but the utilities for that home can exceed $2,300—and this not a consideration!

For QM to really work, we need to go back to the drawing board and build a model that accounts for the utility costs. Ideally, the condition of the home and estimate of maintenance costs would also be a consideration as would the location (Americans, on average, spend a whopping 17% of their income on transportation. A home located near amenities—stores, schools, work, mass transit—would be quite a savings in monthly expenses). Why count taxes and insurance when utilities are significantly more? There are energy efficient mortgage programs that allow borrowers to add energy improvements to the mortgage loans. These are largely ignored.

If you're considering a car purchase most likely you'll look at the MPG sticker and that may play a part in your decision. It's long overdue for homes to have an MPG sticker. It already exists and is called the HERS (Home Energy Rating System) Index.

QM is wired wrong because loan underwriting has been wired wrong all along. Energy costs do impact affordability and ability to repay. I've seen two homes, both at about 2500 square feet, where one carried utility bill of $500 a month and the other only $100 per month. That differential should be a consideration when looking at a borrower's ability to repay.

Let's get the Qualified Mortgage fixed. One place to start is look at the SAVE ACT, a bi-partisan effort that would count utilities as part of the home lending process and require disclosures of the utility costs to potential homebuyers.

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