Include Household Expenses to Better Assess Borrower's Ability to Pay

Published on **2 Apr 2013** | Written by **philip henderson** | Posted in **Advocacy and policy**

Photo by Jay Coble

This article was originally posted on americanbanker.com on April 2, 2013

Since the 1930s, when the Federal Housing Administration published its earliest underwriting manuals, mortgage lenders have used a loan applicant's debt-to-income ratio to measure his or her ability to pay a mortgage loan. But lenders today typically count only a limited basket of loan applicant expenses toward DTI: the new mortgage payment, taxes and insurance and other loan payments.

Lenders leave out many major expenses of homeownership, which is one reason DTI is incomplete, an unreliable predictor of loan performance and a coarse measure of ability to pay.

Recent studies strongly suggest a homeowner's utility expenses and transportation expenses can be meaningful determinants of delinquency, default and prepayment. A new study by University of North Carolina economists found 30% better loan performance for Energy Star houses, and another paper found better loan performance for houses in "location efficient" neighborhoods.

The natural response to these facts is to ask whether lenders could do a better job of assessing a loan applicant's expected utility and car expenses as part of their ability-to-pay analysis.

Since most people in the mortgage industry are steeped in today's DTI methodology, it is helpful to sketch how a lender might account for these two major household expenses and to explain why it makes sense for lenders to lead the effort to improve the ability-to-pay determination.

To estimate utility expenses, lenders could follow the method used by the U.S. Department of Veterans Affairs' mortgage program. VA uses the square footage of the house and a standard expense factor of 14 cents per square foot. Local utilities could deliver an actual metric for average utility expenses per-square-foot for houses in the area to improve the accuracy of the method. If the house has an energy rating or is an Energy Star house, the expense estimate could be further adjusted. And, for refinance loans, utility companies could report the customer's actual average monthly bill amount.

Car expenses for many borrowers are larger than the mortgage loan payment itself, yet today, lenders routinely undercount these expenses in DTI, considering only outstanding car loan payments. The estimate of car expenses should be adjusted to account for total cost of car ownership using regional averages for insurance, fuel and maintenance expenses, and should account for the cost of all cars owned by the loan applicant, not just those purchased with a loan.

For purchase mortgages – where the loan applicant will be in a new house after the loan – lenders should adjust total car expenses based on the new neighborhood. There is strong data available online outlining how average car expenses vary in a substantial and reliable way depending on attributes of the neighborhood, such as distance to commercial areas and access to public transit.

Loan servicers have become adept at accounting for borrower utility and car expenses at the loan modification table, but this is obviously too late. Accounting for these expenses at origination will not only help the lender make a better decision, but if disclosed to the loan applicant in the loan application process – just as insurance premiums and property taxes are – it could help the borrower select an affordable house.

Assessing the expenses a loan applicant is expected to have as homeowner is not a new concept. FHA advised lenders to consider expected prospective "operating expenses" in its earliest underwriting manuals in the 1940s and 1950s. Lenders appear to have moved away from the practice in the 1960s. This could have been because the process was laborious in the era of manual underwriting. Today, lender systems can gather the needed information automatically.

The necessary first step is for lenders to regularly collect a better estimate of utility and transportation expenses for all loan applicants. Once the data is understood, lenders and their regulators can determine exactly how it should fit into the loan decision process. Doing so would ultimately help lenders and investors make better loan decisions, encourage homebuyers to select affordable houses and support a more sustainable housing market.

Philip Henderson is senior financial policy specialist at the Natural Resources Defense Council, and works with policymakers, utilities and other institutions on policies and programs to enable builders and homeowners to invest in energy efficiency.

philip henderson
Natural Resources Defense Council

0 comments

Leave a comment

Leave a comment

Don't have an account? Create one

You must be signed in to leave a comment.

Email

Password

SIGN IN