How Much Can You Afford?

Introduction

An old rule of thumb said that you could afford to buy a house that cost between one and a half and two and a half times your annual salary. In reality, there's a lot more to take into consideration. You'll want to know not only how much of a mortgage you qualify for, but also how much you can afford to spend on a home. In order to know how much you can truly afford, you need to take an honest look at your lifestyle and your standard of living, as well as your income and what you choose to spend it on.

Getting to the bottom line

If you have unlimited resources, you can afford to buy whatever home your heart desires. For most of us, though, that's not the case.

Unless you can afford to buy a house outright, you'll probably need to get a mortgage to help you pay for it. So, determining how much house you can afford is often a case of determining how much of a mortgage you can afford.

Start with some simple math: Take your monthly income and subtract all of your non−housing−related expenses. What you're left with is the amount per month that you have available to allocate toward housing.

Other housing expenses to factor in

In determining what you can afford to spend on a home, you should also take into account other housing−related expenses. The total amount of expenses may depend in part on what type of home you buy and where it's located. Such expenses include:

- Maintenance costs−−everything from weekly rubbish removal to a new roof
- Utility costs−−electricity, heating and/or air−conditioning, gas, water and/or sewer
- Homeowner association fees or condominium assessment fees

Deduct the monthly portion of these expenses from what you estimated your monthly housing allowance to be, and you're getting close to determining how much of a monthly mortgage payment you can afford. Of course, mortgage lenders have a slightly more sophisticated way of determining how much they think you can afford.

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Lenders use qualifying ratios

Lenders use formulas called qualifying ratios to calculate how much of a mortgage you qualify for. These ratios are based on your gross monthly income, your housing expenses, and your long−term debt.

The first qualifying ratio a lender scrutinizes is your housing expenses to income ratio. According to the Government National Mortgage Association (Ginnie Mae), in order to qualify for a conventional mortgage (one not insured or guaranteed by the federal government), your housing expenses generally should not exceed 25 to 30 percent of your gross monthly income. Your monthly housing expenses include mortgage principal, interest, taxes, and insurance; consequently, this ratio is often abbreviated as PITI. The ratio is also known as the front ratio.

The second ratio that a lender looks at (known as the back ratio) is one that takes into account your expenses that extend 11 months or more into the future (e.g., a car or student loan). These expenses are considered long−term debt. Your monthly housing expenses, plus your other long−term debt, determine what's known as your debt ratio, or PITIO. To qualify for a conventional mortgage, Ginnie Mae indicates that the total of these expenses should be no more than 33 to 38 percent of your gross monthly income.

> **Example(s):** If your gross annual income is $30,000, your gross monthly income is $2,500. Your front ratio (PITI) should not exceed more than 30 percent of this, or $750. Your back ratio (PITIO) should not exceed $950 (38 percent of $2,500).

Mortgages that are insured or guaranteed by the federal government may allow more liberal qualifying ratios. Federal Housing Administration (FHA) loans may allow front ratios as high as 33 percent and back ratios of 41 percent, while Department of Veterans Affairs (VA) loans may allow up to 41 percent for both ratios. Remember that the figures provided are estimates. Qualifying ratios may vary from lender to lender, and each mortgage application is considered individually. Lenders generally use both ratios, since the two provide information about different aspects of your total financial picture.

Mortgage prequalification and preapproval

Consider shopping for your mortgage before you start shopping for your house. Compare the mortgage rates and terms offered by various lenders, and then get preapproved or prequalified with the lender of your choice. That way, you'll know how much you can spend on a house before you fall in love with one that's just out of your reach. Make sure you understand the difference between prequalification and preapproval.

Prequalification is simply the process of estimating how much money you'll be able to borrow based on the qualifying ratios appropriate for the type of mortgage you're considering. Preapproval, on the other hand, means the lender has verified your income and checked your credit references. Once you're preapproved, you'll get a letter stating that the lender will give you a mortgage up to a certain amount, provided that certain conditions are met (e.g., the property is appraised for an amount sufficient to cover the mortgage). Preapproval lets you know exactly how large a mortgage you can get. It also gives you more credibility as a buyer, since the preapproval letter lets the seller know

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that you'll qualify, financially, for a mortgage if your purchase offer is accepted.

Make sure you really can afford it

Remember that mortgage lenders can only tell you how much of a mortgage you qualify for, not how much you can afford. If homeowners insurance and property taxes are escrowed with your lender, these expenses will increase your monthly mortgage payment. The payment amount will be even more if you're required to carry specialty policies such as flood or earthquake insurance in addition to homeowners insurance. And if property taxes are especially high, you may find that you're unable to afford the home. See Property Taxes for more information.

> **Tip:** Keep in mind that your actual mortgage payment will also depend on your interest rate and the term of the loan. Generally speaking, lower rates of interest and longer terms equal lower monthly mortgage payments.

Now might be the time to think about revising your budget. Perhaps you can think of ways to reduce your non−housing−related expenses; doing so will free up money that you can apply toward your housing costs. For more information, see The Spending Plan (Budget) .

Also keep in mind any future plans that may affect your budget. Perhaps you'll need to buy a new car in a few years. If you haven't already done so, perhaps you'll be starting a family soon. If you have children, as soon as they're in kindergarten you'll need to think about saving for their college expenses. No matter how much of a mortgage a lender tells you that you qualify for, you must always be sure your mortgage payment is not beyond your means. After all, it's the roof over your head.

Final Page - Disclaimer

See disclaimer on final page.