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Mortgages: How much can you afford?

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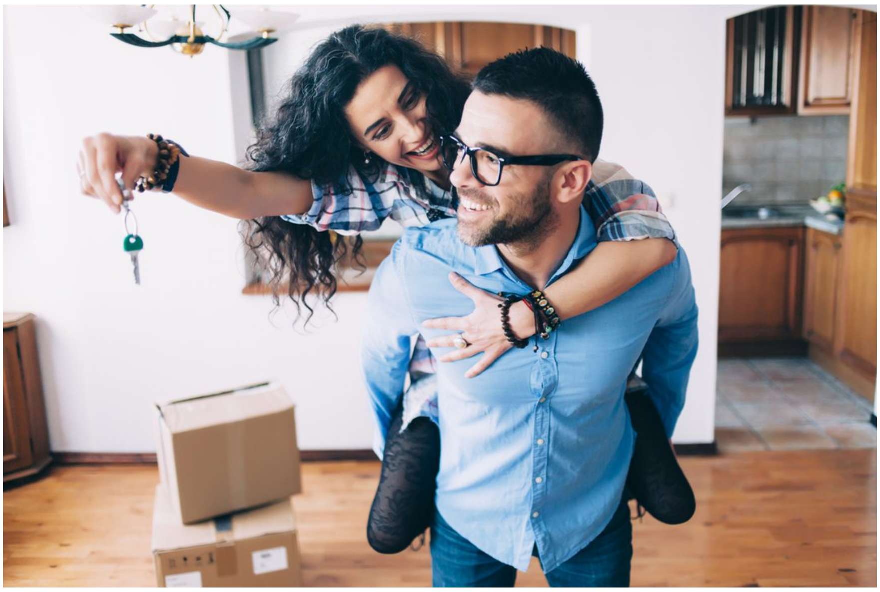
The housing slump hasn't entirely ended. But in many parts of the country, residential real estate is coming back big time, and – even allowing for the negotiating wiggle-room built into asking prices – even starter homes can carry six-figure tags these days. So it's not surprising if your gut reaction is: "Can I afford that?" But unless you're planning an all-cash transaction, your reaction should be, more specifically: "Can I afford to *borrow* that?"



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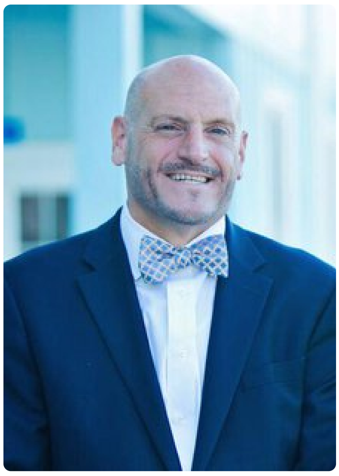
Generally speaking, most prospective homeowners can afford to finance a property that costs between 2 and 2.5 times their gross income. Under this formula, a person earning $100,000 per year can afford a mortgage of $200,000 to $250,000. But this calculation is only a general guideline. You can use Investopedia's mortgage calculator to estimate monthly payments.

Ultimately, when deciding on a property, you need to consider a few more factors. First, it's a good idea to have an understanding of what your lender thinks you can afford (and how it arrived at that estimation). Secondly, you need to determine some personal criteria by evaluating not only your finances, but also your preferences and priorities.

Lender's Criteria



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While each mortgage lender determines its own criteria for affordability, your ability to purchase a home – and the size and terms of the loan you merit – depends largely on the following factors:

Gross Income is the level of income that a prospective homebuyer makes before income taxes. This is generally deemed to be salary plus any bonus income, and can include part-time earnings, self-employment earnings, Social Security benefits, disability, alimony and child support. Gross income plays a key part in determining the front end ratio.

Front-End Ratio is the percentage of your yearly gross income that can be dedicated toward paying your mortgage each month. Your mortgage payment consists of four components (often collectively referred to as PITI): principal, interest, taxes and insurance, both property insurance and private mortgage insurance. A good rule of thumb is that PITI should not exceed 28% of your gross income. However, many lenders let borrowers exceed 30%, and some even let borrowers exceed 40%.

Back-End Ratio, also known as the debt-to-income ratio (DTI), calculates the percentage of your gross income required to cover your debts. Debts include credit card payments, child support and other outstanding loans (auto, student, etc.). In other words, if you pay $2,000 each month in expenses and you make $4,000 each month, your ratio is 50%: Half of your monthly income is being used to pay debt.

Here's the bad news: A 50% debt-to-income ratio isn't going to get you that dream home. Most lenders recommend that your DTI not exceed 36% of your gross income. To calculate your maximum monthly debt based on this ratio, multiply your gross income by 0.36 and divide by 12. For example, if you earn $100,000 per year, your maximum monthly debt expenses should not exceed $3,000. The lower the DTI ratio, the better.

Credit Rating. If one side of the affordability coin is income, then the other side is risk. Mortgage lenders have developed a formula to determine the level of risk for a prospective homebuyer. The formula varies but is generally determined by using the applicant's credit score. An applicant with a low credit score can expect to pay a higher rate of interest, also referred to as an annual percentage rate (APR), on his loan.

At this point, we have to say: If you know that you're going to be looking for a home in the future, work on your credit score now. And you must keep a close eye on your reports. If there are inaccurate entries, it will take time to get them removed and you don't want to miss out on that dream home because of something that is not your fault. There's something else that can offset negative entries in your credit report, and that involves the...

Down Payment is the amount that the buyer can afford to pay out-of-pocket for the residence, using cash or liquid assets. For example, if a prospective homebuyer can afford to pay 10% on a $100,000 home, the down payment is $10,000, which means that the homeowner must finance $90,000. A down payment of at least 20% of the purchase price of the home is typically demanded by lenders (and the minimum required to avoid needing private mortgage insurance), but many let buyers purchase a home with significantly smaller percentages. Obviously, however, the more you can put down, the less financing you'll need, and the the better you look to the bank.

In addition to the amount of financing, lenders also want to know the number of years for which the mortgage loan is needed. A short-term mortgage has higher monthly payments, but it may be less expensive over the duration of the loan.

How Lenders Decide

Many different factors go into the mortgage lender's decision on homebuyer affordability, but they basically boil down to income and debt, assets and liabilities. Sometimes we think that our mortgage applications are judged by a person who uses a gut feeling rather than objective criteria, but in fact, even if your mortgage lender was having a bad day, you can rest assured that much of the process is formulaic.

A lender wants to know how much income an applicant makes and how many demands there are on that income, and the potential for both in the future – in short, anything that could jeopardize its ability to get paid back. Income, down payment and monthly expenses are generally base qualifiers for financing, while credit history and score determine the rate of interest on the financing itself.

Personal Criteria

The lender may tell you that you can afford a huge estate, but can you really? Remember, the lender's criteria look largely at your gross pay. The problem with using gross pay is simple: You are factoring in money – often as much as 30% of your paycheck, what with taxes, FICA deductions and health insurance premiums – that you don't actually have to spend. Even if you get a refund on your tax return, that doesn't help you now – and how much will you really get back?

That's why some financial experts feel it's more realistic to think in terms of your net income, aka take-home pay, and that you shouldn't use any more than 25% of your take-home on your mortgage payment. Otherwise, while you might be literally able to pay the mortgage monthly, you might well be "house poor." The costs of paying for and maintaining your home could take up such a large percentage of your income – far and above the nominal front-end ratio – that you don't have enough money left to cover other discretionary expenses or outstanding debts, or to save for retirement or even a rainy day.

As grim as that sounds, many people choose this course because they believe that it's wise to purchase the most expensive home within reach, regardless of how far they have to stretch. Their theory is that, over time, their income will increase as a result of raises, promotions and new jobs, making that onerous mortgage a smaller and smaller percentage of their monthly expenses. They may also be banking on their property appreciating to a large extent, making the purchase a good long-term investment.

The decision of whether or not to be "house poor" is largely a matter of personal choice – since getting approved for a mortgage doesn't mean that you can actually afford the payments. So, in addition to the lender's criteria, consider the following issues when contemplating your ability to pay a mortgage.

Income. Are you relying on two incomes just to pay the bills? Is your job stable? Can you easily find another position that pays the same, or better, wages if you should lose your current job? If meeting your monthly budget depends on every dime you earn, even a small reduction can be a disaster.

Expenses. The calculation of your back-end-ratio will include most of your current debt expenses, but what about other expenses that you haven't generated yet? Will you have kids in college someday? Do you have plans to buy a new car, truck or boat? Does your family enjoy a yearly vacation?

Lifestyle. Are you willing to change your lifestyle to get the house you want? If fewer trips to the mall and a little tightening of the budget don't bother you, applying a higher back-end-ratio might work out fine. If you can't make any adjustments, or you already have considerable credit card account balances, you might want to play it safe, and take a more conservative approach tin your house-hunting.

Personality. No two people have the same personality, regardless of their income. Some people can sleep soundly at night knowing that they owe $5,000 per month for the next 30 years, while others fret over a payment half that size. The prospect of refinancing the house in order to afford payments on a new car would drive some people crazy while not worrying others at all.

Beyond the Mortgage

While the mortgage is certainly the largest financial responsibility of homeownership, there are a host of additional expenses, some of which don't go away even after the mortgage is paid off. Smart shoppers would do well to keep the following items in mind:

Maintenance. Even if you build a new home, it won't stay new forever, nor will those expensive major appliances, such as stoves, dishwashers and refrigerators. The same applies to the residence's roof, furnace, driveway, carpet and even the paint on the walls. If you are "house poor" when you take on that first mortgage payment, you could find yourself in a difficult situation if your finances haven't improved by the time your home is in need of major repairs.

Utilities. Heat, light, water, sewage, trash removal, cable television and telephone services all cost money. These expenses are not included in the front-end ratio, nor are they calculated in the back-end ratio. But they are unavoidable for most homeowners.

Association Fees. Many neighborhoods or planned communities assess monthly or yearly association fees. Sometimes these fees are less than $100 per year, other times they are several hundred dollars per month. In some communities, they includes lawn maintenance, snow removal, a community pool and other services. In others, the association fee covers little more than the administrative costs of hiring an attorney to encourage everyone in the neighborhood to maintain the exterior appearance of their homes. While an increasing number of lenders include association fees in the front-end ratio, it pays to remember that these fees are likely to increase over time.

*Furniture and Décor***.** Drive through almost any community of new homes after the sun goes down, and you're likely to notice some interior lights illuminating big, empty rooms, which you can see only because those big, beautiful houses don't have any window coverings. This isn't the latest decorating trend. It's the result of a family that spent all their money on the house, and now can't afford curtains or furniture. Before you buy a new house, take a good look around the number of rooms that will need to be furnished and the number of windows that will need to be covered.

The Bottom Line

The cost of a home is the single largest personal expense most people will ever face. Prior to taking on such an enormous debt, take the time to do the math. After you run the numbers, consider your personal situation, and think about your lifestyle – not just now, but into the next decade or two. That dream home may be everything you've wanted at a great price now, but is it worth overextending yourself and your family? Will you be mortgaging not only your house, but your entire lives as well? A lender helps you buy a home. But the real person who should decide if you can actually afford it is you.