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How Much House Can You Afford?

Debt-to-Income Ratios

To determine your maximum mortgage amount, lenders use guidelines called debt-to-income ratios. This is simply the percentage of your monthly gross income (before taxes) that is used to pay your monthly debts. Because there are two calculations, there is a "front" ratio and a "back" ratio and they are generally written in the following format: 33/38.

The front ratio is the percentage of your monthly gross income (before taxes) that is used to pay your housing costs, including principal, interest, taxes, insurance, mortgage insurance (when applicable) and homeowners association fees (when applicable). The back ratio is the same thing, only it also includes your monthly consumer debt. Consumer debt can be car payments, credit card debt, installment loans, and similar related expenses. Auto or life insurance is not considered a debt.

A common guideline for debt-to-income ratios is 33/38. A borrower's housing costs consume thirty-three percent of their monthly income. Add their monthly consumer debt to the housing costs, and it should take no more than thirty-eight percent of their monthly income to meet those obligations.

The guidelines are just guidelines and they are flexible. If you make a small down payment, the guidelines are more rigid. If you have marginal credit, the guidelines are more rigid. If you make a larger down payment or have sterling credit, the guidelines are less rigid. The guidelines also vary according to loan program. FHA guidelines state that a 29/41 qualifying ratio is acceptable. VA guidelines do not have a front ratio at all, but the guideline for the back ratio is 41.

Example: If you make $5000 a month, with 33/38 qualifying ratio guidelines, your maximum monthly housing cost should be around $1650. Including your consumer debt, your monthly housing and credit expenditures should be around $1900 as a maximum.

Step One - Calculating Your Monthly Income

When a loan officer pre qualifies you, he works backwards to figure your maximum mortgage amount. You can do the same thing. The first step is to determine your monthly income. It isn't quite as easy as it sounds. Lenders only count income they can document through paperwork.

If you are a salaried employee, and don't earn bonuses, it's easy. Get out your paycheck. If you get paid twice a month, multiply by two. If you are paid every two weeks, then you multiply by 26 (the number of pay periods in a year) and divide by twelve. Unless you're a teacher. Teachers don't always work year round and they have special rules.

If you are an hourly employee who works a straight forty hours a week and don't earn overtime income, then it's easy, too. Look at your paycheck, multiply your hourly rate by 40, multiply that total by 52, then divide by twelve.

If you earn overtime, bonuses, or commissions -- it isn't as easy. Lenders don't give you credit for what you are currently earning. They average your income from those sources over the last two years, then add that to your regular salary or hourly monthly income. If you want a shortcut that is usually close, get out your W2 forms for the last two years. Add them together and divide by twenty-four. That is your monthly income.

If you are a teacher, a nurse, a seasonal employee, in construction, or earn only part-time income -- you can use that shortcut, too. Add the figures from your last two years W2's, then divide by 24. It generally gets you close.

If you are self-employed or receive 1099 income, then you need a two-year track record. Lenders go by what you declare to the IRS as income, since that is documentable. Since some self-employed people overstate their expenses, this may understate your income. Look at the Schedule C of your tax returns for the last two years and the number at the bottom that says "profit" is your annual income. You can add any depreciation to that figure. Add them together and divide by twenty-four.

There are variations and exceptions (like those who own their own corporations) but the above should cover most people.

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Step Two - Working Backward

Once you have calculated your monthly income, multiply it by the back ratio for your particular loan. For generic purposes, it is fairly easy to work with thirty-eight. Take 38% of your monthly income or multiply it by .38. That tells you the maximum the lender wants you to spend on your housing costs and monthly consumer debt combined.

Now get out your bills and total them up to determine what you spend monthly on debt. Do not include your auto insurance or your utilities. Just creditors. For credit cards, use the minimum required monthly payment unless it is less than ten dollars. The rest should be fairly straightforward.

Deduct that amount from the total the lender wants you to spend on housing costs and consumer debt combined. Now you know the maximum the lender wants you to spend for housing costs, unless the figure is greater than 33% of your monthly income (there are exceptions, of course).

Step Three - a Little Guesswork

The next step requires a little guesswork. If you have a vague idea of what price you might qualify for, you can estimate what your annual property taxes and homeowners insurance might cost. From there, you can easily calculate the monthly equivalent. Subtract those figures from your maximum monthly housing costs total.

If you are buying a condominium (or an area with HOA fees), subtract out an approximate figure to cover homeowners association fees. What you are left with is your maximum principal and interest payment.

Final Step - Almost

Now you have to go to a mortgage calculator (click here) and plug in some numbers. In the "payment" area, put the figure you just calculated. Plug in the current fixed interest rate. If you are putting less than twenty percent down, add a half percent to the rate to allow for charges you will pay for mortgage insurance.

Hit the calculate button and you should have your maximum mortgage amount. Add your down payment and you know your maximum purchase price.

Maybe. You may have to do some fine-tuning to zero in on the exact figure. Plus, lenders know how to "stretch" a client a bit higher if they need it.

Advice

If the figure is less than you expected (or need), lenders know programs that will help "boost" you h qualifying. Plus, they will do what you just did for free, they are much more experienced at the various involved, and you will have no obligation to use them.