How Much Home Can You Afford?

Description

Taking out a mortgage is probably the biggest hassle facing prospective homeowners. The bank asks you all sorts of nosy questions about your income and savings, and after you've poured your heart out and shared all your money secrets, they might not even lend you as much as you need. The nerve!

Of course, they do have a point. Put yourself in the bank's shoes: If you were going to lend people money, what would you want to know about them? Of course you'd want to know whether:

1. They make enough money to pay you back.
2. They've been trustworthy in the past.
3. They have something of value to trade, should they be unable to pay you back.

Congratulations: In financial parlance, you've just been introduced to the concepts of income, credit worthiness, and collateral — the three main factors that go into the lending decision. Let's look at each one, and how they affect what you can afford.

Do you make enough to pay the lender back?

Your lender will want to know not only how much money you have, but also how much you will likely make over the next 30 years. Also, what are your other debts? Do you owe money for post secondary education loans or credit card charges? Do you have any other assets? Things like stocks and mutual funds, or personal property like a boat or a car, are also considered in figuring out how much a bank will lend you.

In terms of rules of thumb as to how much they may lend, you can use a couple of formulas: the front-end ratio (having to do with your mortgage payments) and the back-end ratio (having to do with your debt).

For instance, let's say your gross income is $4,000 a month, and you have $400 a month in debt payments. A common rule of thumb is that they'll allow you to pay around 30% of your gross income toward your mortgage payment every month. This is known as the front-end ratio. In this example, 30%

of $4,000 is $1,200 a month — so, they'll reason, you can afford put $1,200 toward your mortgage payment.

Your debt ratio, or back-end ratio, on the other hand, is $400/$4,000, or 10%. That's not bad. They don't want more than around 40% of your gross income going to total debt — mortgage, credit card interest, and other payments — and in this case, your payments add up to 39%. (These ratios can vary somewhat; the ones given here are just examples).

Have you been trustworthy in the past?

Potential mates aren't the only ones curious about your past. Your lender wants to know your history, too, before deciding whether or not to commit. Your credit report — a nifty little compilation of your personal financial history — will reveal whether you have a track record of paying your bills on time. If you are concerned prior to going to loan shopping, check with the Canadian offices of both Equifax and Transunion to get an idea of what your credit report looks like. If you see anything unsavory, clean it up to make yourself more attractive to lenders.

Do you have any collateral?

The house you buy will generally be considered collateral for your mortgage. As a result, in case you can't repay the loan, the bank can decide to do something really nasty: foreclose on the mortgage and repossess the house. You will find yourself out on the street — with your dog, your La-Z-Boy, your collection of unpublished poetry, a couple of suitcases, and your toiletries kit. Your house now belongs to the bank, and it is unlikely that anyone will ever loan you money again. Hot tip: *Avoid this scenario at all costs*.

Now, let's discuss your needs

How much you make, your creditworthiness, and how much collateral you have are all questions from the *bank's* point of view, because the amount of house you can afford is largely a question of how big a loan you can afford. Now, let's look at a few things from *your* point of view.

Your timeline

To determine whether you should buy a new home, think about how long you're planning to stay in it. It generally doesn't make economic sense to buy if you're only planning to stay there for a couple of years. Since you'll be paying fees to buy and then sell your house, it would have to appreciate in value very quickly while you're living there to make the entire deal financially worthwhile.

Your comfort zone

Before you borrow $100,000, $200,000, or whatever you need for your mortgage, figure out whether you can really afford it. Just because the bank will loan it to you doesn't mean that you'll be able to pay it back — at least, not without cutting into other goals that may be a priority for you. Are you planning to have a big family? Would you rather spend money on travel or spoiling the grandkids?

Remember, your house payment is just one piece of your financial puzzle. Carefully consider what you might need to give up to make that house a reality, and ask yourself whether you're *really* willing to do it.

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apape