

You should know what you can afford before beginning your search for a home. This enables you to focus on realistic choices and saves you time and effort.

This section will show you how to calculate the amount you comfortably can spend for a home.

What is the difference between a front-end and a back-end debt-to-income ratio?

Before making a loan, the lender wants to be certain the borrower has the ability to repay. Before approving your mortgage loan application a lender will look at several factors to gauge the risk you pose as a borrower. There are two calculations your lender makes when determining your level of indebtedness.

The *front-end* ratio divides your total monthly housing payments by your before-taxes monthly income, expressing the result as a percentage.

The following chart gives some examples of how this computation works:

Table 4-1: Computing a Front-End Debt-to-Income Ratio

If your monthly housing cost is...	And each month you earn...	Your front-end debt-to income ratio is...
\$875 rent	\$3,750 (based on \$45,000 annual income)	23% (\$875 divided by \$3,750)
\$1,250 mortgage + \$50 condo fee	\$5,000 (based on \$60,000 annual income)	26% (\$1,300 divided by \$5,000)
\$820 mortgage	\$3,000 (based on \$36,000 annual income)	27% (\$820 divided by \$3000)
\$550 rent	\$2,291 (based on \$27,500 annual income)	24% (\$550 divided by \$2,291)

A lower percentage means you're using a smaller portion of your monthly income to housing expenses, while a higher percentage means you're dedicating a larger portion of your monthly income to housing expenses.

For a mortgage loan application, your lender will calculate a front-end ratio for the loan amount you request. Generally, your lender will want to see a front-end ratio below 29%. If the ratio is higher, you may have trouble getting the loan approved. The reason is obvious. As you increase the percentage of your monthly income dedicated to a mortgage, you increase the possibility you may have trouble repaying the loan.

You can use the following worksheet to compute your own front-end ratio:

Table 4-2: Calculate Your Front-End Ratio

My monthly housing cost.		
• Mortgage/rent payments		\$
• Condo/co-op/community association fees		
Total monthly housing cost		\$
<p>An important step in calculating your <i>front-end ratio</i> is figuring your monthly income - what you earn before taxes or other deductions are made.</p> <ul style="list-style-type: none"> • If you're paid every other week, multiply your gross salary by 26, then divide by 12. This is your gross monthly pay. • If your income is inconsistent, estimate your monthly income by dividing last year's gross annual income by 12. 		
My monthly income - Remember to include income from all sources including:		
• Gross income from job(s)		\$
• Alimony and child support		
• Bonuses, commissions, and/or tips		
• Dividends and interest		
• Other income		
Total gross monthly pay		\$
My front-end ratio is:		
\$ _____	\$ _____	_____ %
My total housing cost income equals...	My gross monthly divided by...	My front-end ratio

The *back-end* ratio compares the amount of your total monthly debt payments to your monthly gross income. When figuring your total monthly debt payments, you should add up your current minimum monthly payments for all credit accounts and loans. Be sure your list of expenses includes:

- Housing expenses.
- Car payment(s).
- Loan payments (for furniture, appliances, etc.).
- Bank/credit union loans.
- Student loan payments.
- Other loans/credit accounts.
- Credit card payments.
- Payment for past medical care.

To determine your back-end ratio, simply divide your total monthly debt payments by your total gross monthly income from all sources.

Table 4-3: Computing a Back End Debt-to-Income Ratio

If your total monthly debt payments are...	And each month you earn...	Your back end debt-to-income ratio is...
\$875 rent + \$410 debt payments = \$1,285	\$3,750 (based on \$45,000 annual income)	34% (\$1,285 divided by \$3,750)
\$1,250 mortgage + \$50 condo fee + \$645 debt payments = \$1,945	\$5,000 (based on \$60,000 annual income)	39% (1,945 divided by \$5,000)
\$820 mortgage + \$145 debt payments = \$965	\$3,000 (based on \$36,000 annual income)	32% (\$965 divided by \$3000)
\$550 rent + \$375 debt payments = \$925	\$2,291 (based on \$27,500 annual income)	40% (\$925 divided by \$2,291)

The lower your back-end ratio is, the better your financial condition. The first step in calculating your back-end ratio is calculating your before-tax monthly income.

- If you're paid every other week, multiply your gross biweekly salary by 26, then divide by 12. This is your gross monthly income.
- If your income is inconsistent, estimate your monthly income by dividing last year's total gross annual income by 12.

Table 4-4: Calculate Your Back-End Ratio

Monthly income - Remember to include income from all sources including:		
• Gross income from job(s)		_____
• Alimony and child support		_____
• Bonuses, commissions, and/or tips		_____
• Dividends and interest		_____
• Other income		_____
Total gross monthly income		\$ _____
Monthly debt payments - Use minimum amounts due on credit card and other loan accounts.		
• Mortgage/rent payments		_____
• Condo/co-op/community association fees		_____
• Car payment(s)		_____
• Bank/credit union loan		_____
• Student loan payment		_____
• Other loans/credit accounts		_____
• Credit card payments		_____
• Payment for past medical care		_____
• Other credit accounts		_____
Total monthly debt payments		\$ _____
My back-end ratio is:		
\$ _____	\$ _____	_____ %
My total debt payments	My gross monthly	My back-end ratio
Divided by...	income equals.....	

If your back-end ratio is:

- **Below 28%** - Congratulations! Your ratio is in a good range to help you qualify for the best terms on a low-interest mortgage loan. You'll look even better when you pay off your debt completely.
- **28-30%** - Your ratio is not bad, but as you approach 36%, you are placing a greater financial burden on yourself.
- **30-32%** - This may be a signal that your debt has become burdensome. Carefully review your budget to determine if your debt is temporary or a more serious problem.
- **34-36%** - You should look for ways to decrease expenses or increase your income. With a ratio this high, you may not qualify for reasonable mortgage loan terms. If you have had this ratio for over a year, you need to act now to reduce your debt if you really intend to buy a home.
- **36-43%** - Your ratio is too high. Start reducing your debt. At this level you will have difficulty obtaining a mortgage loan or other credit. You may have difficulty paying your bills. Begin by establishing and following a budget designed to reduce your debt as soon as possible.

Although each situation is different, a front-end ratio higher than 28%, or a back-end ratio higher than 36%, signals a need to lower your debt and control your use of credit - before attempting to purchase your dream home. If your ratios are higher than the standard 28/36, a lender may lower the amount of mortgage you qualify for, or deny your mortgage loan application. However, if your ratios are low, a lender may approve a larger mortgage that allows you to buy a more expensive home.

In order to qualify for a Federal Housing Agency-backed loan, you must have a front-end ratio at or lower than 31% and a back-end ratio at or lower than 43%. To qualify for a Fannie Mae or Freddie Mac-backed loan, you must have a front-end ratio at or lower than 28% and a back-end ratio at or lower than 36%.

If you calculate your front- and back-end ratios before contacting a real estate agent or loan officer, you'll have an idea of where you stand on getting a loan application approved. And, if you're thinking about making any major credit purchase, you'll be better off waiting until after you purchase a home.

What is a loan-to-value ratio?

A loan-to-value ratio, or LTV, is a comparison of the amount of money borrowed on a mortgage to the appraised value of a home. LTVs are expressed as percentages. For example, a 95% LTV means the lender provides 95% of the home's value and the borrower provides a down payment of 5% of the home's value. A high LTV means the borrower is making a small down payment. A lower LTV means the borrower is making a larger down payment. In general, the lower the LTV percentage, the easier it will be to get your loan approved.

Lenders prefer to see lower LTVs because borrowers who put down large amounts of their own cash are less likely to default. For a high LTV loan, a lender will require the borrower to purchase mortgage insurance to protect the lender's investment. This insurance will be included in the monthly mortgage payment and will increase the cost of the mortgage.

On conventional mortgage loans, loans not guaranteed or insured by a government agency, lenders are free to set their own LTV guidelines. The standard is 80/20, or 80% of the purchase price provided by the lender and 20% provided by the homebuyer as a down payment. However, many federally backed loans such as VA guaranteed loans or Fannie Mae assistance programs designed for low or moderate-income buyer offer pre-set LTVs that range from 100/0 to 95/5.

A home seller may also be interested in your LTV if the home is appraised for less than the asking price. The lender will use either the asking price or the appraised value, whichever is lower, to compute the LTV. If the asking price is high, but the appraised value is low and you cannot afford to increase your down payment amount, the deal could fall through.

How can I calculate my monthly payments?

You can estimate your approximate affordable monthly mortgage payment by reversing the steps used to calculate your back-end ratio.

Multiply your monthly gross income by .36 and then subtract your monthly debt payments (not including housing expenses) from the total.

This would be the amount you could afford to pay each month on a mortgage. Look at the examples in the following chart.

Table 4-5: Estimating an Affordable Monthly Mortgage Payment

The Lee Family has a gross monthly income of \$4,500...		Kelly McDonald has a gross monthly income of \$2,482...	
\$4,500	Income	\$2,482	Income
<u>x .36</u>	Standard ratio	<u>x .36</u>	Standard Ratio
\$1,620	Total debt payments	\$894	Total debt payments
...and they spend \$598 each month on debt payments, other than housing expenses.		...and he spends \$312 each month on debt payments, other than housing expenses.	
\$1620	Total debt payments	\$894	Total debt payments
<u>-\$598</u>	Non Housing debt	<u>-\$312</u>	Standard Ratio
\$1,022	Est. mortgage payment (inclusive of taxes and insurance)	\$582	Est. mortgage payment (inclusive of taxes and insurance)
Ines Ortiz has a gross monthly income of \$3,633...		The Jefferson family has a gross monthly income of \$5,252...	
\$3,633	Income	\$5,252	Income
<u>x .36</u>	Standard Ratio	<u>x .36</u>	Standard Ratio
\$1,319	Total debt payments	\$1,891	Total debt payments
...and she spends \$610 each month on debt payments, other than housing expenses.		...and they spend \$683 each month on debt payments, other than housing expenses.	
\$1,319	Total debt payments	\$1,891	Total debt payments
<u>-\$610</u>	Non Housing debt	<u>-\$683</u>	Non-housing debt
\$709	Est. mortgage payment (inclusive of taxes and insurance)	\$1,208	Est. mortgage payment (inclusive of taxes and insurance)

The amount of your monthly mortgage payments will depend on the size of your loan, your interest rate, and the length of your repayment period. The bigger your mortgage and the higher your interest rate, the more you'll pay each month. The longer your repayment period is, the lower your monthly payments. On an adjustable-rate mortgage, your monthly payments will vary according to up-or-down changes in the interest rate.

You can use the following chart to get an estimate of what you'll pay each month based on the following:

- A fixed interest rate.
- The amount you borrow.
- A 30-year repayment period.

Table 4-6: Approximate Monthly Mortgage Payment Amounts

If you borrow...	And the fixed interest rate on a 30-year loan is...									
	5%	5.5%	6%	6.5%	7%	7.5%	8%	8.5%	9%	9.5%
\$25,000	\$134	\$141	\$150	\$158	\$166	\$175	\$183	\$192	\$201	\$210
\$50,000	\$268	\$284	\$300	\$316	\$332	\$350	\$367	\$384	\$402	\$420
\$75,000	\$402	\$426	\$450	\$474	\$499	\$524	\$550	\$577	\$603	\$631
\$100,000	\$536	\$568	\$600	\$632	\$665	\$699	\$734	\$769	\$805	\$841
\$125,000	\$671	\$710	\$749	\$790	\$832	\$874	\$917	\$961	\$1006	\$1051
\$150,000	\$805	\$852	\$899	\$948	\$998	\$1049	\$1101	\$1153	\$1207	\$1261
\$175,000	\$939	\$994	\$1049	\$1106	\$1164	\$1224	\$1284	\$1346	\$1408	\$1471
\$200,000	\$1073	\$1136	\$1199	\$1264	\$1331	\$1398	\$1468	\$1538	\$1609	\$1682
\$225,000	\$1208	\$1278	\$1349	\$1422	\$1497	\$1573	\$1651	\$1730	\$1810	\$1892
\$250,000	\$1342	\$1419	\$1499	\$1580	\$1663	\$1748	\$1834	\$1922	\$2011	\$2102
\$275,000	\$1476	\$1561	\$1659	\$1738	\$1830	\$1923	\$2018	\$2115	\$2213	\$2312
\$300,000	\$1610	\$1703	\$1799	\$1896	\$1996	\$2097	\$2201	\$2307	\$2414	\$2523

These estimates include principal and interest payments only. Remember that a mortgage payment typically consists of **Principal, Interest, Taxes and Insurance (PITI)**. You should familiarize yourself with taxes and insurance in the area you plan on looking so that you can add those amounts to the monthly payment. For example, if a property has annual taxes of \$2400, you divide this by 12 for a monthly tax payment of \$200. If the annual insurance is \$900, your monthly contribution will be \$75. You can then add \$275 to the above totals for a good idea of what your monthly payment would be, at different purchase prices and interest rates.

You may also be required to pay periodic mortgage insurance if you do not have a significant down payment. This cost should also be added to your projected monthly payment.

What other expenses will occur?

When you purchase a home, you'll be required to pay certain one-time costs. These include:

- **Down payment** - The amount of this payment will depend on the type of loan you get and how much money you have available.
- **Closing costs** - These are costs for a variety of services including fees for the loan application, credit report, appraisal, attorney's services, document preparation, as well as a title search and title insurance policy. You'll also pay an amount for escrow deposits to cover pro-rated taxes and insurance. After your loan is approved, but before you go to closing, your lender will provide an itemized list of all the one-time fees you'll have to pay.

- **Moving expenses** - These include the costs of packing and shipping your household property and paying any required deposits for telephone service or utilities.
- In addition to your monthly mortgage payments, you'll have scheduled expenses that may include:
- **Insurance premium payments** - for all the personal property in your new home.
- **Monthly utility bills** - electricity, gas, water and sewer, telephone, and cable TV.

Although these costs may seem substantial, keep in mind that some of these expenses will be offset by the tax advantages you'll gain as a homeowner. When you file your income tax return, you may be able to deduct the cost of mortgage interest, and some of the fees you pay at closing. Money you pay for property taxes may also be deductible. Keep all records of your home purchase well organized for tax time.

What money can you use for a down payment?

How much money do you have available to buy a home? The following table shows how to list all the resources you can identify to determine how much cash or assets you can convert to cash.

Table 4-6: Compute Your Available Cash

Source of Available Funds	Amount
Checking account - self	\$ _____
Checking account - co-borrower	_____
Savings account - self	_____
Savings account - co-borrower	_____
Life insurance policies - cash value	_____
Stocks, bonds, or mutual funds - cash value	_____
Cash gifts from relatives	_____
Other sources	_____
Total Available Funds	\$ _____

Enter your sources of cash including any assets you can convert to cash to cover the one-time costs associated with purchasing your home. Although government-guaranteed loans and private mortgage insurance have made it easier than ever to qualify for a home loan, you'll save money over the life of your mortgage loan if you can increase the size of your down payment. You'll still need to have cash on hand to cover one-time expenses such as closing costs and moving costs.

Be realistic when entering your figures. After all, your loan officer will check your bank statements for checking and savings account balances. It's best not to use all of your savings. You should try to maintain enough money in savings to cover three to six months of regular expenses. In addition, you may need funds for emergencies that arise during the first few years in your new home, before you've had time to build up a reserve account.

Your investments in stocks, bonds, or mutual funds can provide another source of ready cash. Also, family can contribute to your home-purchase fund.

As you calculate your available cash, always keep in mind that you should be able to provide a reasonable explanation for ALL funds in your possession. Your loan officer will check your bank accounts and credit report to be certain that you aren't using cash advances on your credit cards to buy your home. Relatives who donate money toward your down payment will have to declare that they don't expect you to repay their gifts.

Deposit Assistance Programs have been a valuable resource for many homebuyers who have a seller that is willing to pay a portion of the buyer's purchase expenses.

Summary

A front-end/back-end debt-to-income ratio greater than 31/43 could make it difficult to get a mortgage loan at terms you can afford.

- Lenders see a low loan-to-value ratio as support for a less risky loan.
- The size of your monthly mortgage payments depends on the amount of your loan, cost of taxes and insurance, your interest rate and the length of your repayment period.
- Tax advantages for homeowners will offset many costs of buying a home.

“If this world affords true happiness, it is to be found in a home...where luxuries enter only after their cost has been carefully considered.”

-A. Edward Newton