Home Buying Affordability

Buying a house is big deal financially. Given the tough times we are currently in and the more restricted lenders are with their money, the process of buying a home has become even more difficult. Should you buy now or wait? How much should you put down? How much can you afford? These are all typical questions that should be asked. I will address each one individually below.

Should You Buy Now or Wait?

To begin, no one knows when the housing market will bottom. We could hit bottom tomorrow or not for another 5 years. Historically, home prices have risen with inflation, roughly 2-3% per year. The past 15 years were definitely out of the norm. So when should you buy? Every person's situation is different. If you have a stable job, a sizeable down payment, plan to be in the house for at least seven years, and are ready to be a homeowner, now might make sense for you.

How Much Should I Put Down?

With more restricted lending practices, you will be required to put down 20%, unless you are approved for an FHA loan, where the down payment is 3.5% (subject to change). Regardless which path you take, I recommend putting 20% down. The reason is two-fold. First, the more you have to put down, the less the loan you will be taking out, saving you money in the long run. The second reason is because with price uncertainty, if you only put down 3.5% and prices drop 5%, you are suddenly underwater, meaning you owe more on your house than it is worth. Be conservative and put down 20%.

How Much House Can I Afford?

There is a formula out there for home buying. There are 3 parts to it, summarized below:

Rule of 28: Your monthly mortgage payment (principal and interest) should not exceed 28% of your gross monthly income. So, if you make $50,000 per year, your gross monthly income is roughly $4,167 and 28% of that is $1,167. In this example, your monthly mortgage payment should not exceed $1,167.

Rule of 32: You total monthly mortgage payment (principal, interest, taxes and insurance) should not exceed 32% of your gross monthly income. Using our figure of $50,000 above, our total payment cannot exceed $1,333.

Rule of 40: Your total monthly debt payments should not exceed 40% of your gross monthly income. So, 40% of your monthly gross income is $1,667. If I use the

$1,333 figure from above, all of your other monthly debt payments (credit card, car loan, student loan, etc) cannot be more than $334.

This has been the formula for many years. I do not like it for a few reasons. First of all, it is misleading. It is taking into account gross income versus what you actually bring home, your net pay. You are grossing $50,000 but you pay taxes, health insurance premiums, and contribute to your retirement plans, so your net income (your take home pay) is less than that.

Here is an example: Let us say you find a home and calculated a mortgage payment of $1,333. You compare that to your gross monthly income of $4,167 and think there is no problem. You can afford that. But if you look at your net income, you are only bringing home $2,700 per month. Roughly half of your take home pay is going towards your mortgage!

Instead, use this formula to determine how much house you can afford. Take your annual salary and multiple it by 1.75. This is the largest sized loan you can take out. This includes principal, interest, taxes, and insurance. Using our $50,000 annual income, you can afford a total loan of $87,500. Realize that this is not the price of the home you can buy. This is simply the loan amount. If you put 20% as a down payment, the home purchase price is $109,375 with $21,875 as down payment and an $87,500 loan (109,375 x 20% = 21,875; 21,875 + 87,500 = 109,375). If you are saying that you cannot find a home that cheap in your area, then you need to save more for the down payment.

Trust me with this formula. You do not want to be house poor. House poor is when you buy too much of a house. You don't realize it at the time, but the cost of maintaining a home adds up. When you rent, you are only responsible for the rent each month. If something needs to be fixed or upgraded, it isn't your problem. But with a house, it is. Being house poor is not fun. You have to cut every other expense just to get by, if you can get by at all. There are sleepless nights and days of worry. Buy a house you can easily afford. Even if when you buy a house that you think is perfect, you will find issues. You will want to upgrade this or replace that. And that costs money. Before you know it, you are up to your eyes in credit card debt from updating and remodeling. Or you can look at it this way, the more space you have means the more things you have to buy to fill that space. You aren't going to leave rooms completely empty. You'll turn them into something. Whatever that something is will cost you money.

If after reading this you still feel as though the 1.75 formula is too conservative, then try this technique. Use the old rule, the Rule of 32 to come up with the maximum amount you can pay each month for housing related expenses. Again, this includes

principal, interest, taxes and insurance. We will use the $1,333 from above as an example. Take out what you currently pay for rent. We will use $1,000. Now for the next year transfer an additional $333 into savings. By doing this, it will force you to financially act as though you are paying the housing payment of $1,333 per month. If over the course of the year you do this and find that you have easily survived financially, then you can consider taking out a loan larger than my formula of 1.75 times income. However, I feel that many of you will find that doing this will make you realize that a smaller loan amount, one that conforms to the 1.75 times income is the way to go.

If you have any questions or comments, feel free to contact me on my website, MoneySmartGuides.com. I also have some calculators that you may find useful when figuring out your housing wants and needs.

Good Luck!!