Can You Afford This Loan?

This Chapter will try to protect you from foreclosure by showing you:

- How lenders determine whether or not you can afford your payment.
- How life ***really*** works – how you can determine what you can actually afford.

Any number of things can happen that can result in a foreclosure:

1. **Unexpected, negative events** – No matter how hard you plan, things like losing your job, divorce, disability, or a long-term illness can happen.
2. **Unrealistic expectations** – Sometimes, we want a home so badly that we are willing to delude ourselves into thinking we can afford it, when we can't. This chapter will help you be honest with yourself.
3. **Expecting to get something for nothing** – If you paid for a real estate seminar that taught you how to get something for nothing, you just wasted your money. In real life, everything we receive comes with a price to pay on our end. Anyone who tells you differently is trying to sell you something that benefits him at your expense.
4. **Choosing the wrong loan for your lifestyle** – Some foreclosures happen when a loan rate adjusts and the homeowner cannot afford the new payment. The next chapter helps you calculate what may happen to your payment when the loan adjusts.

Lifestyle Assessment

Bad things can happen to good people; and I know of no way to prevent those things from happening *all* of the time. However, we can be as prepared as possible. Being honest about your lifestyle and spending habits, and being willing to change your habits, will go a long way toward helping you keep your home in the event that unexpected negative events happen to you.

Back in the mortgage "boom days" those of us in the business half-jokingly said that if you had a pulse, you could get a mortgage. When clients asked me how much they qualified for, I had a problem. In reality, most could get pretty much whatever size loan they wanted. To protect them from possible future foreclosure, I would take time to determine the mortgage payment that they could most comfortably afford, and then backed into the loan amount from there. I called that the "Can you sleep at night?" mortgage payment. Even today, with most loans requiring full income documentation, a lifestyle assessment is an important part of determining what my clients can comfortably afford.

This chapter will help you do the lifestyle assessment that will help you determine your own "sleep at night" payment amount, and give you confidence that you can manage your mortgage payment(s) now and in the future.

The Lender's Math

Lenders have guidelines that are meant to help you avoid getting in over your head. Most lenders want your **overall monthly debt** to be somewhere between 38% and 45% of your gross monthly income. This is called "DTI," or debt-to-income ratio (a.k.a. Back-End Ratio). Some Lenders want to make sure that your **total housing payment** is no more than 28% to 33% of your gross monthly income (a.k.a. Front-End Ratio).

However, in real life there are other factors that come into play when determining the loan you can comfortably afford. It makes sense to do *their* math, and then take it a step further by taking into account how you actually live your life. When you do an honest assessment, you are opening your eyes to the reality that will hit you in the future, whether you choose to acknowledge it or not. After honestly assessing your lifestyle, you may decide to make changes, so that you can comfortably afford the home of your dreams.

The Front-End Ratio is calculated by adding "PITI" and dividing by your gross monthly income (income before taxes are taken out). PITI is Principal + Interest + Taxes + Insurance (including an HOA fee, if you have one), or your total monthly housing expense. Most lenders would like that ratio to be about 33%. For example, if your monthly housing expense is $2,000, they want to see before-tax income of $6,000 per month.

Front-End Ratio Calculation:

PITI ÷ Gross Monthly Income

In reality, though, many lenders only care about the Back-End Ratio. That is calculated by adding PITI and all other monthly debt that shows up on your credit report, and then dividing that number by your gross monthly income. Debt that counts against you in the Back-End ratio includes:

1. Car payments;
2. Student loans (they usually count even when they are in deferment);
3. Credit card payments (Note: Lenders often calculate their own minimum payment for your credit cards, and do not use your real one. Many use 2% to 5% of your outstanding debt as your minimum payment);
4. If you are buying a second home or investment property, they will count the PITI for your primary home in the Back-End Ratio, as well as the PITI of the new property.
5. If you are buying investment property or already own some, keep in mind that most lenders will count the full PITI against you, but only 75% of the rental income *for* you. This is due to the "vacancy factor." They assume the property won't be rented 100% of the time and that you will have repair expenses to deal with.
6. If you pay alimony or child support, some lenders take that amount off your income; others count it as a debt. If a lender counts child support as a debt, it makes the DTI higher than if they take it off of your income. If you pay child support, you may want to discuss this issue with your lender up front and make sure you qualify by their standards.

Back-End Ratio Calculation:

(PITI + All Other Monthly Debt) ÷ Gross Monthly Income

Example: DTI Calculation (Back-End Ratio)

Item	Monthly Payment
Car Payment	$300
Student Loans	$150
$5,000 in credit card debt	$100
Mortgage Payment for a $400,000 Mortgage	$2,528
Property Taxes	$520
Homeowner's Insurance	$140
Total Monthly Debt	**$3,738**

Gross Monthly Income lender's want to see if they allow a 45% Back-End Ratio in this circumstance is: $3,738 ÷ 45% = $8,307.

The lender's guidelines are well thought-out and work most of the time. However, life happens. Let's take other factors into account now. You may want to ask yourself the questions in the box on the following page, and add a few questions of your own. Each of us is unique. Our best protection from getting in over our heads is to know ourselves, our strengths and weaknesses and our habits; and then take all of those into account before choosing a home loan.

Becoming aware of our spending tendencies is the first step. The next is to determine how much we are willing to change in order to manage the mortgage payment for the home we want. In my experience, life always requires balancing what we want against the price we have to pay to achieve it (financially or otherwise).

Lifestyle Assessment

1. How often do you like to eat out? Would you be willing to eat at home more often if it helped you afford your dream home?
2. Are you conservative or "passionate" in your spending? Are you willing to become more conservative?
   a. Do you buy a lot of clothes, jewelry or accessories?
   b. Do you want a new car every few years?
   c. Do you have expensive hobbies?
   d. Are you likely to have a manic moment and buy a luxury item (i.e. boat, Jet Ski, additional vehicle)?
3. Do you have children?
   a. Are they in private school or college, or will they be attending college soon?
   b. Do they have any special needs that require unusual cash outlays?
4. Do you like to gamble? Do you control yourself and keep to pre-set spending limits, or do you have a history of getting carried away while gambling?
5. If you are buying a house, please try to estimate fairly how much work you will want to put into it when you move in and then look at the costs involved, and how much you will spend on furniture and appliances. This factor is the most overlooked of all, and the point I drive home to my clients, if I have any concern at all that they are stretching their budget too thinly (especially when I work with first-time home buyers).

Income Flexibility

Income flexibility is an area that lenders have no way to accurately assess. But you know yourself and can include this factor when you are determining the "Can I sleep at night?" mortgage payment.

Many of us work as hard as we need to work in order to achieve what we really want in life. It is easy to get stuck in a mindset which says that the money we are making now is all that we can reasonably expect to make in the near future. However, in my experience, most of us can do more than we are doing now if we are properly motivated. Would the promise of a home you *really love* make you go into a higher gear and earn more?

I want to motivate myself to be the best I can possibly be. That is one of the reasons I chose to keep my home, even after my children grew up and moved out. The house payment and costs of maintenance of my home are challenging; and affording it keeps me on my toes. I never want to allow myself to get lazy. My responsibilities ensure that I will always work hard.

I think that, for all of us, there is a zone somewhere between laziness and overwork that is a wonderful sweet spot. It is a place that is challenging enough to cause us to grow, without being so challenging that we get overwhelmed and fail. I try to stay in that zone. My hope is that you will, also.

Income Fluctuations

It is easier to assess how much home you can afford if your income is fairly steady. If you are self-employed, that assessment can be much more challenging. Whether your income is steady or highly volatile, ask yourself if your income is likely to increase, decrease, or stay pretty much the same over the coming years. This factor is very important when deciding the type of loan you want to get for your home.

- ➢ **If your income is likely to increase substantially in the next few years**, choosing an interest only Hybrid ARM whose rate is fixed for 3 to 10 years may make sense, because your risk will be mitigated by the likelihood of greater income when the loan adjusts. Obviously, this is only valid if the fixed rate loan payment is higher than the Hybrid ARM payment, which is usually the case. If you save the difference in payment between a Hybrid ARM and a comparable fixed rate mortgage, and earn interest on it, you are in a better position than you would be if you chose the fixed rate mortgage. When the loan adjusts, your payment *may go down*. If the payment goes up when it adjusts, you will have money in the bank to cushion the blow.
- ➢ **If your income fluctuates wildly,** an Option ARM may be the best loan for you.
- ➢ **If your income is likely to remain steady** in the foreseeable future, a fixed rate loan whose payment is well within your comfort zone is often the best choice.

➢ **If your income is likely to decrease** (possibly because you are approaching retirement), either choose a loan that will pay off your home before your income decreases, or choose your mortgage payment based on what your income will become after it decreases.

Back-up Plans

I get a very uneasy feeling if my clients live too much on the edge and do not have sufficient back-up plans. I try to help them by advising them to have more than one back-up plan in the event their situation changes unexpectedly. Back-up plans include:

1. **Savings** – It is wise to save a percentage of your income off the top. There is a little book you may enjoy that makes this point very well, called "The Richest Man in Babylon."It is a story that drives home the importance of saving a portion of your income regularly. If possible, save 10% of your income. If you can't see yourself doing that, then please save any percentage possible. Even 2% savings will grow over time and make you feel good about yourself. As you feel good about your ability to save, you may decide to increase the percentage of your income that you save and invest.
2. **Additional income possibilities** – ideas include:
    a. Possibly a spouse who stays home with the children could work at least part-time to supplement the household income in the event that the main bread winner is disabled or loses his or her job, or expenses unexpectedly increase
    b. An additional job
3. **Credit** – I do not like to rely on credit as a back-up plan because everyone has to pay the piper one day. However, a line of credit or credit cards can help in an emergency. This should be your "safety net" of last resort.
4. **Family** – Some people have loving family or friends who are willing to support them in times of need. Others have trust accounts or other sources of family money that can be tapped if needed.
5. **Other** – You may have other back-up plans than those I suggested here. Whatever your situation, please put in place at least two back-up plans when you own a home.

Our Math

Determine your new net income - To realistically assess the mortgage payment you can afford, you first have to determine what your net income will become with the new mortgage payment. Mortgage interest and property taxes are tax deductible (up to a limit). If you have a CPA or tax preparer, ask him or her to reassess the taxes you will need to pay taking into account the new deductions for mortgage interest and property taxes. If you prepare your own

tax returns, your tax preparation program may have a feature that helps you determine how much you will save in taxes with your proposed loan and property taxes.

To reasonably assess expenses, here are a few ideas:

- ➢ If you are buying a home, call the utility companies and get a history for the last year's usage by the current owners. Your habits may be different, but this at least gives you a good idea of what your bills may become. The yard in my current home is larger than in my previous home. Before I moved in, I called the Department of Water and Power to get a history. It was a real eye-opener. The water bill was substantially higher, but at least I was prepared for it so that it didn't hit me unexpectedly between the eyes.
- ➢ If you use *Quicken*, *MS Money* or a similar program, getting a history of how you spend your money is easy. If you do not, use whatever method you have to determine your past living expenses (e.g. review your checkbooks, bank statements and credit card statements).
- ➢ Determine where you can cut the fat. Another author wisely calls this the "latte factor." With the right incentive, you may be willing to make your own coffee at home to save money, or eat out less, or change any number of other habits.

On the next page is a table that can help you assess your lifestyle and determine what you can actually afford. Some expenses fluctuate, so put the highest and lowest expense amounts for each category over the last 12 months, and take both into account for the final analysis. You can choose whatever time frame is best for you (i.e. monthly or yearly). Enter your current lifestyle in the "Current Expense" fields. I left blank spaces for expenses you incur that I do not have on the list. Include your possible new housing payment, future utilities, and other home expenses (maintenance and upgrades) in the "Possible Change" fields.

When you have the chart filled in, add all of the expenses and subtract them from your income. If your results are a negative number, you may choose to look over all the expenses and see where you can make some cuts so that the income and expenses balance. Put the possible new expenses that are based on changes you are willing to make in the "Possible Change" field next to its description. Then do the math again until it balances.

Some people do not want to take the time to analyze income and expenses. But even if it takes you a couple of hours to complete this exercise, it may save you countless sleepless nights in the future. If you have a clear understanding of your income and expenses, you will feel confident that you can comfortably afford your lifestyle.

Description	Current Expense		Possible Change
	High	Low	
Housing (PITI)			
Credit Card Payments			
Car Payments			
Gas			
Car Repairs			
Education			
Utilities			
Food			
Restaurants			
Entertainment			
Home Maintenance (i.e. gardener, pool)			
Home Repairs and Upgrades			
Insurance (other than homeowner’s)			
Personal Care			
Medical (doctor, prescriptions, etc.)			
Clothes (including dry cleaning)			
Hobbies			
Savings			
Vacations			
Total Expenses			
Income			
Income minus Expenses			

Another factor to consider if you choose an adjustable rate mortgage (ARM) is that your housing payment may change in the future. If you choose an ARM, please read the chapter that describes how they work. You will learn how to calculate the best and worst case scenarios when your loan adjusts.

Sleep on it

Your choice of mortgage has potentially life-changing consequences. It is important to do all the proper analyses before choosing a home loan. However, I also ask my clients to sleep on it before making a final decision. I have learned that the creative right brain is at least as powerful an ally to wise decision-making as the analytical left brain, if not more so. I recommend that you allow all the information to sink in over whatever period of time you need; and then honor your gut instinct as well as your analysis when choosing your home loan.

Chapter Summary:

Your best protection from possible foreclosure is to be honest with yourself about your present and foreseeable income and expenses. Your willingness to change goes a long way toward creating the lifestyle you want, and helping you keep your home. Lenders try to determine what you can afford with DTI (debt-to-income ratios). However, there is nothing better than an honest analysis on your part.