# Are You Ready to Buy a Home?

Oak Tree Capital

Providing Financial Solutions

**If you feel like you're ready to buy a house,** the first question you're likely to ask yourself is "how much can I afford?" Answering that question means taking a look at a number of factors.

Before you snap up that seemingly great buy on a home, learn how to analyze what "affordability" means. You'll need to consider various factors ranging from the debt-to-income (DTI) ratio to mortgage rates.

**KEY TAKEAWAYS**

- Determining your debt-to-income ratio (DTI)—more specifically, the front-end DTI—is an important factor in getting a mortgage.
- Beyond the property's price tag, a host of other financial and lifestyle considerations should figure into your calculations as to whether you can afford to buy a house.
- You should also evaluate the local real estate market, the economic outlook, and the implications of how long you want to stay put.
- You'll also need to consider your lifestyle needs, present, and future.

Understand Your Debt-to-Income Ratio First

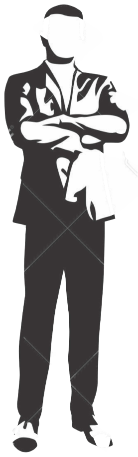
The first and most obvious decision point involves money. If you have sufficient means to purchase a house for cash, then you certainly can afford to buy one now.

Even if you can't pay in cash, most experts would agree that you can afford the purchase if you can qualify for a mortgage on a new home. But how much mortgage can you afford?

The 43% debt-to-income (DTI) ratio standard is generally used by the Federal Housing Administration (FHA) as a guideline for approving mortgages.1 This ratio is used to determine if the borrower can make their payments each month. Some lenders may be more lenient or more rigid, depending on the real estate market and general economic conditions.

A 43% DTI means all your regular debt payments, plus your housing-related expenses—mortgage, mortgage insurance, homeowners association fees, property tax, homeowners insurance, etc.—shouldn't equal more than 43% of your monthly gross income.

For example, if your monthly gross income is $4,000, you multiply this number by 0.43 to get $1,720, which is the total you should spend on debt payments. Now, let's say you already have these monthly obligations: Minimum credit card payments of $120, a car loan payment of $240, and student loan payments of $120—a total of $480. That means theoretically you can afford up to $1,240 per month in additional debt for a mortgage, and still be within the maximum DTI. Of course, less debt is always better.



Mortgage lending discrimination is illegal. If you think you've been discriminated against based on race, religion, sex, marital status, use of public assistance, national origin, disability, or age, there are steps you can take.

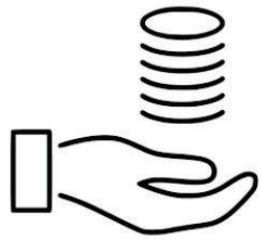
One such step is to file a report to the Consumer Financial Protection Bureau or with the U.S. Department of Housing and Urban Development (HUD).

**What Mortgage Lenders Want**
You also need to consider the front-end debt-to-income ratio, which calculates your income vis-à-vis the monthly debt you would incur from housing expenses alone, such as mortgage payments and mortgage insurance.

Usually, lenders like that ratio to be no more than 28%. For example, if your income is $4,000 per month, you would have trouble getting approved for $1,720 in monthly housing expenses even if you have no other obligations. For a front-end DTI of 28%, your housing costs should be under $1,120.

Why wouldn't you be able to use your full debt-to-income ratio if you don't have other debt? Basically, because lenders don't like you living on the edge. Financial misfortunes happen—you lose your job, your car gets totaled, a medical disability prevents you from working for a while. If your mortgage is 43% of your income, you'd have no wiggle room for when you want to or have to incur additional expenses.
Most mortgages are long-term commitments. Keep in mind that you may be making those payments every month for the next 30 years. Accordingly, you should evaluate the reliability of your primary source of income. You should also consider your prospects for the future and the likelihood that your expenses will rise over time.

Getting approved for a mortgage up to a certain amount doesn’t mean you can actually afford the payments, so be honest about the level of financial risk that you are comfortable living with.



**Can You Afford the Down Payment?**
It's best to put down 20% of your home price to avoid paying private mortgage insurance (PMI). Usually added into your mortgage payments, PMI can add $30 to $70 to your monthly mortgage payment for every $100,000 borrowed.

There may be some reasons that you might not want to put down 20% toward your purchase. Perhaps you aren't planning on living in the home very long or have long-term plans to convert the home into an investment property. Similarly, you might not want to put that much cash down. If that's the case, buying a home is still possible without 20% down.

You can buy a home with as little as 3.5% down with an FHA loan, for example, but there are bonuses to coming up with more.5 In addition to the aforementioned avoidance of PMI, a larger down payment also means:

- Smaller mortgage payments—for a $200,000 mortgage with a 4% fixed interest rate for a 30-year term, you would pay $955. If your mortgage were $180,000 with a 4% interest rate for a 30-year term, you'd pay $859.
- More choices among lenders—some lenders won't offer a mortgage unless you put at least 5% to 10% down.

Being able to afford a new house today is not nearly as important as your ability to afford it over the long haul. Needless to say, being able to afford a house and having a down payment doesn't answer the question of whether now is a good time for you to act on that option.

While there are many benefits to a larger down payment, don't sacrifice your emergency savings account completely to put more down on your home. You could end up in a pinch when unexpected repairs or other needs arise.

**The Housing Market**
Assuming you have your personal money situation under control, your next consideration is housing-market economics—either in your current locale or the one where you plan to move. A house is an expensive investment. Having the money to make the purchase is great, but it doesn't answer the question of whether or not the purchase makes sense from a financial perspective.

One way to do this is to answer the question—is it cheaper to rent than to buy? If buying works out to be less expensive than renting, that's a strong argument in favor of purchasing.



Similarly, it's worth thinking about the longer-term implications of a home purchase. For generations, buying a home was almost a guaranteed way to make money. Your grandparents could have bought a home 50 years ago for $20,000 and sold it for five or 10 times that amount 30 years later.

While real estate has traditionally been considered a safe long-term investment, recessions and other disasters can test that theory—and make would-be homeowners think twice.

During the Great Recession many homeowners lost money when the real estate market crashed back in 2007, and ended up owning homes that were worth far less than the price at which they were purchased for many years after.

If you are buying the property on the belief that it will rise in value over time, be sure to factor the cost of interest payments on your mortgage, upgrades to the property, and ongoing or routine maintenance into your calculations.

**The Economic Outlook**
Along those same lines, there are years when real estate prices are depressed and years when they are abnormally high. If prices are so low that it is obvious you are getting a good deal, you can take that as a sign that it might be a good time to make your purchase. In a buyer's market, depressed prices increase the odds that time will work in your favor and cause your house to appreciate down the road.

It's too soon to tell what will happen to home prices in 2021. But if history repeats itself, we can expect a drop in home prices as a result of the COVID-19 pandemic and its dramatic impact on the economy.

**Interest Rates**
Interest rates, which play a large role in determining the size of a monthly mortgage payment, also have years when they are high and years when they are low.

Obviously, lower is better. For example, a 30-year mortgage (360 months) on a $100,000 loan at 3% interest will cost you $422 per month. At a 5% interest rate, it will cost you $537 per month. At 7%, it jumps to $665. So if interest rates are falling, it may be wise to wait before you buy. If they are rising, it makes sense to make your purchase sooner rather than later.

**Time of Year**
The seasons of the year can also factor into the decision-making process. If you want the widest possible variety of homes to choose from, spring is probably the best time to shop. "For Sale" signs tend to spring up like flowers as the weather warms and lawns turn green. Part of the reason relates to the target audience of most homes: families who are waiting to move until their kids finish the current school year but want to get settled before the new year starts in the fall.

If you want sellers who may be seeing less traffic—which could make them more flexible on price—winter may be better for house hunting (especially in cold climates), or the height of summer for tropical states (the off-season for your area, in other words). Inventories are likely to be smaller, so choices may be limited, but it is also unlikely that sellers will be seeing multiple offers during this time of year.

Some savvy buyers also like to make offers around holidays, such as Christmas or Easter, hoping that the unusual timing, lack of competition, and overall spirit of the season will get a quick deal done at a good price.


EQUAL HOUSING OPPORTUNITY

**Consider Your Lifestyle Needs**
While money is obviously an important consideration, there are a host of other factors that could play a role in your timing. Is your need for extra space imminent—a new baby on the way, an elderly relative who can't live alone?

Does the move involve your kids changing schools? If you'll be selling a house in which you've lived for less than two years, would you incur capital gains tax—and if so, is it worth waiting to avoid the bite?You may love to cook with gourmet ingredients, take a weekend getaway every month, patronize the performing arts, or work out with a personal trainer.

None of these habits are budget killers, but you might have to do without them if you bought a home based on a 43% debt-to-income ratio alone.

Before you practice making mortgage payments, give yourself a little financial elbowroom by subtracting the cost of your most expensive hobby or activity from the payment you calculated. If the balance isn't enough to buy the home of your dreams, you may have to cut back on your fun and games—or start thinking of a less expensive house as your dream home.

**Selling One Home, Buying Another**
If you are selling a home and plan to buy another, save the proceeds from your current home in a savings account and determine whether or not—after factoring in other necessary expenses like car payments or health insurance—you will be able to afford the mortgage. It is also important to remember that additional funds will have to be allocated for maintenance and utilities. These costs will undoubtedly be higher for larger homes. When you calculate, use your current income, and don't assume you'll be making more money down the road. Raises don't always happen, and careers change. If you base the amount of home you buy on future income, you might as well set up a romantic dinner with your credit cards as you'll end up in a long-lasting relationship with them.

However, if you can handle these extra house costs without extra credit card debt, you can afford to buy a home—as long as you have saved up enough money for your down payment.

**Do You Plan to Stay Put?**
Affordability should be the number one thing you look for in a home, but it's also best to know how long you are going to want to live there. If not, you could get stuck in a home you can't afford in a city or town you're ready to leave.

Many financial experts suggest living in a home for five years before selling it as a guideline. Don't forget to factor in the costs involved with buying, selling, and moving. Also, consider the breakeven point for the mortgage fees associated with the home you are selling. If you can't decide what city or town you are going to live in and what your five-year plan is, it may not be the right time to buy a home.

If you want to buy a home without a five-year plan, purchase one that is priced much lower than the maximum you can afford. You'll have to be able to afford to take a hit if you have to sell it quickly. Another exception: If you work for a company that buys the houses of relocated employees—one name for this is a guaranteed buyout option.

**The Bottom Line**
Are you ready to buy a house? In short, yes—if you can afford to do it. But "afford" isn't as simple as what's in your bank account right now. A host of other financial and lifestyle considerations should figure into your calculations.

When you factor in all these elements, "if you can afford to do it" starts looking more complicated than it first appears to be. But considering them now can prevent costly mistakes and financial problems later. Of course, there is one best time to pounce: When you find the perfect house in the perfect place for sale—at a perfect price.

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