Mortgaging Your Future: How Much You Can Borrow and What It'll Cost

Think of it as a numbers game.

Before you go hunting for your dream home, you need to decide how much you might reasonably pay. That means figuring out how big a down payment you can afford – and how much you can safely borrow.

That, in turn, should prompt you to consider how secure your paycheck is and how much you might earn in the years ahead. After all, you don't want to end up with a monthly mortgage payment you can't afford.

WATCHING THE RATIOS

To get a handle on the issue, try starting with two key ratios. First, consider your "housing ratio," which is the percentage of your monthly pretax income that you might devote to mortgage payments.

A big chunk of that monthly payment will go toward your home loan's principal and interest. But your monthly mortgage payment will likely also include amounts for property taxes and homeowner's insurance. In addition, if you make a down payment of less than 20% of your new home's purchase price, you may need to tack on an additional sum for private mortgage insurance.

Generally, your housing ratio should be no more than 28%. For example, if your gross monthly income is $6,000, your total monthly mortgage payment shouldn't be above $1,680.

As you contemplate how much you might reasonably borrow, also check on your "debt ratio," which looks at the sum of your expected mortgage payment plus any money owed each month on auto loans, credit cards and other debts. As a rule, this debt ratio shouldn't be above 36%. With monthly pretax income of $6,000, that translates into total loan payments – including your proposed mortgage – of no more than $2,160.

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Many lenders use the 28% and 36% ratios as guidelines. But they are only guidelines. When the economy is strong, the ratios may rise, making credit more readily available. When the economy is weak, the ratios are often lowered, reducing the amount of available credit. A weak economy, however, may also lead to lower interest rates, which makes borrowing cheaper and thus can partially offset these tighter lending standards.

Even if the mortgage company is willing to lend you a hefty sum, you shouldn't necessarily borrow the full amount. Instead, think about how much debt you can comfortably handle – and factor that into your home-buying decision.

SELECTING A LOAN

Once you've settled on a home to buy, you will need to get a mortgage. Again, give some thought to how secure your paycheck is and how much you might earn in the years ahead.

For instance, if your paycheck fluctuates – maybe you work on commission or you're a small-business owner – you may want to avoid additional uncertainty and go for a fixed-rate mortgage, where your monthly principal-and-interest payment won't change. Most fixed-rate mortgages are for 15 or 30 years. A 30-year loan will have a lower monthly payment than a 15-year mortgage, but usually charges a slightly higher interest rate.

On the other hand, if you have a steady paycheck and you feel you can handle a monthly payment that may fluctuate, you might consider an adjustable-rate mortgage. Some form of adjustable-rate mortgage may also make sense for those who believe their income will rise in the years ahead or who expect to move or refinance fairly quickly.

The reason: An ARM will often charge a lower interest rate initially. But these mortgages also come with added risk. After an initial term, the interest rate on an ARM will reset periodically, to keep the rate in line with current market interest rates.

For example, a 3/1 ARM offers a fixed rate for the first three years, adjusting once a year thereafter. Similarly, a 5/1 ARM offers a fixed rate for the first five years. Most ARMs have both a periodic

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rate cap and a lifetime cap, thus limiting the amount the interest rate can increase each adjustment period and over the life of the loan.

You can also lower the interest on your mortgage by paying an up-front sum known as "points." That may make sense if you figure you'll have the mortgage for a fairly long time. But if you think you will move or refinance relatively soon after buying, paying points might not be a smart move, because you may not have the mortgage long enough to get much benefit from the lower rate.

In addition, you could reduce your mortgage rate by aiming to take out a conforming loan. A conforming loan is one that's eligible for purchase by the government-sponsored entities Fannie Mae and Freddie Mac. For 2010 and 2011, the conforming loan amount for Fannie and Freddie loans is typically $417,000. In certain higher-cost housing areas, the conforming amount can be significantly higher.

If your mortgage is conforming, it should be easier to find a lender and the interest rate may be lower. By contrast, a non-conforming "jumbo" loan can be harder to obtain, and you will likely also pay a slightly higher rate.

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