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With Eyes Bigger Than Their Wallets, Homebuyers Are Forced to Revisit Old Rules

By TARA SIEGEL BERNARD

At the height of the housing boom, many borrowers had to stretch to afford a house, in some cases agreeing to spend half their monthly earnings on their home. We all know how that turned out.

Now, President Obama's housing plan will help many borrowers reduce those monthly payments to 31 percent.

But is that a reasonable goal? And where did that number come from?

Its roots may go back more than a century to company towns, where employers would collect a week's wages for a month's rent. In the 1920s, as homeownership became an option for more middle-class families, lenders adopted a similar standard: spend a quarter of a month's income on housing. And during the New Deal, governmental housing agencies also adopted that as a reasonable amount to spend on a mortgage. Though the number has inched up through the years, that general rule of thumb has stuck.

But does it still work?

Several financial planners agree that a figure around 30 percent is not a bad place to start. That usually leaves enough to pay for life's many other costs.

Given that the current economic crisis has turned a lot of financial assumptions on their head, it is probably wise to rethink how much of your income should go toward servicing the large debt that is truly homeownership.

There is not a one-size-fits-all answer.

“It’s different for everybody, but there are some norms,” said Joseph R. Birkofer, a financial planner and principal of Legacy Asset Management in Houston.

Several financial advisers recommend reverting to an old standard known as the 28/36 rule. Using that rule, households should spend no more than 28 percent of their gross income on housing costs — including mortgage payments, property taxes and insurance — and less than 36 percent on all debt. The total includes obligations like car payments, student loans, credit cards and medical debt.

There is some debate about whether you should base your calculations on gross income or take-home pay. While some advisers said using gross income was reasonable enough, Mr. Birkofer said he told his clients to apply it to net pay.

“I want people to have more than a house, I want them to have a life, too,” Mr. Birkofer said. “The application of the 28/36 rule can be an eye opener and a ‘go slow’ or ‘reform now’ sign.” The original maxim of a week’s pay for a month’s rent was also based on take-home pay, given that it predates the federal income tax system, which formally started in 1913, said Danilo Pelletiere, research director at the National Low Income Housing Coalition.

Many people are spending much more than that. According to the Census Bureau’s American Community Survey in 2007, the latest available, 38 percent of homeowners with mortgages spend more than 30 percent of their monthly gross income on all housing costs.

And a swath of homeowners was even more thinly stretched. In 2007, nearly 9.17 million homeowners, or about 12 percent of all owners, spent more than half of their gross income on housing costs, according to tabulations of Census data by the Joint Center for Housing Studies of Harvard University.

That left little room for food, gas, transportation, utilities, child care and other expenses like medical bills or insurance, not to mention saving for college and retirement. And it helps explain why so many families are losing their homes to foreclosure.

Some of the advice that follows may seem elementary. But given how far many people have strayed from the basics, now is the right time to revisit some of the lessons our parents and grandparents learned long ago.

HOW MUCH CAN I AFFORD? Your housing budget depends on your situation and priorities. Two-income households with strong earnings potential can probably spend a little bit more than one-income households — as your income rises over the years, your housing costs are likely to become a smaller piece of your expenses. (Of course, that is not necessarily the case if you later buy a bigger house.) The same goes for individuals who have saved extra money or people who may earn less, like teachers, but who are unlikely to lose their jobs. Just be sure you stick with a plain-vanilla 30-year fixed mortgage because payments will remain steady.

Financial advisers use different methods to ascertain what their clients can comfortably afford. Jennifer Hartman, a financial planner in Los Angeles, has her clients write down all of their expenses. She then breaks those down into expenses that are fixed (utilities, groceries, auto expenses, insurance, etc.) and variable (everything else). “The idea is that the variable costs could be reallocated toward housing if the client is willing to give it up,” Ms. Hartman said.

Steve Podnos, a financial planner in Merritt Island, Fla., likes to start by establishing savings goals, and then working backward. He recommends setting aside 10 to 15 percent of your salary, preferably in tax-deferred accounts, and then work with what’s left over for living expenses and housing costs.

DO THE MATH Before you start hitting open houses, sketch out a rough budget based on the 28 percent rule of thumb, using a simple mortgage calculator. For instance, a family that earns $10,000 a month — or about $7,000 after taxes — should keep their total monthly housing costs, including mortgage, taxes and insurance, to about $2,800 a month. In one example, the family may be able to spend $440,000 on a home, or about 3.6 times their annual income, as long as they can come up with a 20 percent down payment (and closing costs). If they finance the remaining $352,000 with a 30-year mortgage with a fixed rate of 5.5 percent, that would translate into a monthly payment of about $2,000, leaving $800 to pay real estate taxes and insurance. That leaves $4,200 of their monthly after-tax income to pay for everything else, giving them some breathing room.

DOWN PAYMENT Currently, many consumers have no choice but to make a sizable down payment. If you do not, or cannot, it will cost you dearly in the form of a higher interest rate or fees. The ability to put down at least 20 percent is often emblematic of your financial discipline and ability to afford the monthly payment.

“If you can’t afford to save 20 percent, you can’t afford to buy a home,” said Francine Duke, owner of Aqua Financial Planning in Vernon Hills, Ill.

TAXES Consider the tax savings associated with buying a home, but do not use it as an excuse to buy more than you can afford. Property taxes and mortgage interest are generally tax-deductible, but only if you itemize your deductions. Itemizing makes sense when your individual deductions exceed the standard deduction, which is $11,400 for married people filing jointly in 2009. For many taxpayers in the 28 percent tax bracket who itemize, a $350,000 mortgage may reduce their tax bill by as much as $5,357 in the first year of the mortgage. Since you pay more in interest in the loan’s early years, your tax savings will decline over time.

RESERVES Ideally, homeowners should have six months of net pay in the bank. But if you halve that figure and save three months of your take-home pay, that generally translates into eight months of payments. That does not account for food and other necessities, but it does provide some cushion. Two-income households can get away with just a few months of savings put aside, but single-breadwinner households should have at least six months.

You also need to account for unforeseen costs. “If you can’t afford a new roof or a water heater, then you can’t afford the house,” Ms. Hartman said.