How Much Can You Afford?

This question alone is enough to strike fear into anyone's heart. The truth is not many people enjoy establishing a remodeling budget-and many just don't. Many homeowners prefer to call a remodeling contractor and expect him or her to create the budget for them, which is not the best way to begin. How do you start off right? You can begin by taking these four easy steps in the right direction:

Step One: Decide how long you plan on staying in your home. The length of time you intend to stay in a home will affect how much money you should invest in it. If you are going to stay in the home for more than ten years, you should spend as much as you are able to create the home of your dreams. However, if you are planning on moving in the near future, you should take care not to over-build for your neighborhood. Look into the real estate comparisons for your area and keep your investment in line with the average home sales price. You don't want to invest thousands of dollars you won't be able to recoup at closing.

Step Two: Make a list of all your debts. You should include any debts you pay on a monthly basis, such as mortgages, car loans, credit cards, and any other items with a fixed monthly payment. This list should not include payments for groceries, utilities, telephone services, or other general expenses. Call this list your monthly expenses.

Step Three: Determine your total gross monthly income. Include all sources of income that you would list on a loan application.

Step Four: Complete the following worksheet to determine how much you can afford to pay for your remodeling project on a monthly basis. These formulas are used when the remodeling project is going to be financed. Warning: Cash is not always the best option!

Calculations 101

Step One - DTI

Lenders use a simple Debt-to-Income (DTI) ratio to determine if a homeowner can afford the additional debt of a remodeling project.

DTI

Enter Your Total Monthly Expenses: $____________________

Add the Estimated Monthly Payment for the Remodeling

Project + $ =___________________

Total = $__________________

Divide the Total by Your Gross Monthly Income: $___________________

DTI % =_____________________

Each lender will approve loans at a specific DTI percentage (most lenders will tell you what their set DTI ratio is, if you ask). For example, if the lender accepts DTI ratios of 45 percent and your DTI ratio is 30 percent, your loan would be approved. However, if your DTI ratio is 55 percent, you would need to find other financing options. Perhaps your lender offers debt consolidation loans that could reduce your DTI ratio, which brings us to the next step:

Step 2 - The Maximum Payment

The next step is to determine the maximum monthly payment you can afford for remodeling. Multiply your monthly gross income amount by the lender's maximum DTI allowance, and subtract your current total monthly expenses, excluding the estimated remodeling payment.

Gross Monthly Income $____________________

Lender's DTI ratio x _______________________

Subtotal = $______________________

Total Monthly Expenses - $ _________________________

Maximum Affordable Payment = $ __________________________

If the last line is negative, you will not be able to borrow from that lender. See step 3 for further options.

STEP 3 - Consolidation

If your DTI ratio was above the lender's accepted percentage, or if your maximum affordable payment was too low, you may want to consider a debt consolidation loan. This would incorporate your current debts into the home improvement loan. Not only does this allow you to roll your debts into what may be a tax deductible loan, it also provides one easy payment for your debts and lowers your DTI percentage. In addition, the interest rate on a debt consolidation loan may be lower, which will save you additional money.