

## Your Maximum Borrowing Capacity

When you apply for a loan, the bank will consider your ability to meet the loan repayments (called serviceability), and the maximum amount that you can borrow. The question is how do they work it out?

It is interesting to know that each bank will work it out in a different way though the principles are the same that is your income, expenses and other commitments are the components of any calculation.

First is your **income**, which includes salary, self-employed income and others such as overtime, bonuses, shift allowance and so on. Some of these may not be included in full since they are not regular or permanent in nature and a proportion of it may be included (e.g. 50%). Some banks may also include Centrelink payments but again it depends on the payment type. Rental income is another item that can be included but only 70% - 80% of it since there are costs associated with generating such income. Once the income has been determined, tax liability is deducted to arrive at the annual net income, which is then divided by twelve months to get the monthly figure.

Second are your **expenses**. Obviously this includes a variety of items such as rent, groceries and food, petrol, school fees and many others. Some banks will use the actual figures provided by the applicant and others will use standardised fixed amounts based on the number of persons in a household (e.g. single, partners and no of children) such as the 'Household Expenditure Measure', and others will use the highest of the two. Again the final figure is divided by 12 months to arrive at the monthly figure.

Third is your current **liability** such as existing loans and credit cards. Although you may have an existing loan with an interest rate of let's say 4.2%, the bank may add 2% - 3% to make it 6.2%. This is called the assessment or qualifying rate, and the reason for this is because the bank is well aware that interest can move upwards and must ensure that you will be able to meet your existing and new loan repayments.

Of quite important is the credit card, which can be very costly in terms of obtaining the loan that you need. The highest the credit limit you have the highest the expense that is added to your commitments. Though even your current outstanding balance is zero the bank will add up 2% - 3% on your credit limit as monthly expense. For example, with a credit limit of \$30,000 the expense is \$600. This amount with an interest rate of 5% over 25 years will reduce your borrowing capacity (as you will see below) by \$102,636, which is significant amount if you need it.

It is therefore important to consider reducing your limit, before applying for a loan, if you think that your financial situation is not very promising.

We now have the three components and we can simply deduct expenses and commitments from net income to arrive at the net monthly amount that is left over. This is the amount that you have on hand and can be

used to pay the instalment of the proposed loan. I should also mention that some banks may deduct a further amount known as buffer (used for unexpected commitments) to ensure that the left over is sufficient.

Knowing the net amount, we can now work out the present value of this net amount, which is the maximum that you can borrow. In case if you don't know what the present value is, the following example will illustrate the point.

Assuming that I have \$1,000 deposited in my bank account where I shall get paid 10% interest. This in one year time from **now** will become \$1,100 that is my original deposit plus \$100 interest (\$1,000 x 10%) or by multiplying \$1,000 by 1.1. This \$1,100 is called the **future** value. Let's reverse the case and see what happens. Assuming that in one year time from now I wish to have in my bank account \$1,100, and knowing that the bank will pay me 10% interest, how much I should deposit **right now** to arrive at my target. Very simply, I shall divide the \$1,100 by 1.1 (the opposite of future value) to get my target, which is called the **present** value. In obtaining a loan, we are making several monthly payments not just one, and we shall use the formula below to arrive at the present value or the maximum borrowing capacity:

$$PV = \frac{C (1 - (1 + x)^{-n})}{x}$$

Where:

PV is the present value

C is the cash outflow or the monthly instalment

x is the monthly interest rate divided by 100

n is the term of the loan in months

Alternatively you can use the PV function in Excel.

The above is just a simple discussion to give you an idea of how much you can borrow, and the reader should understand that things can be more complicated since each borrower has different financial situation.

If you need assistance, please call me on **04 3984 1952** or email **[info@eleganceaccounting.com.au](mailto:info@eleganceaccounting.com.au)**