

Debt To Income Ratio

Debt to income is a ratio of your total monthly debt payments to your total monthly income expressed as a ratio or percentage. It is a rather simple calculation but it can be deceiving unless you include all debt and all income in the calculation.

The calculation of your debt to income ratio is a straightforward one. You simply divide your total monthly debt payments by your total net income (that is your income after taxes). While some debt is unavoidable and may even be desirable for achieving your financial goals the real question is how much debt is too much; just where do you draw the line. Obtaining credit is often a function of a loan officer calculating the debt to income ratio as a way of determining your ability to meet new obligations. Too high a debt to income ratio will also have a negative impact on your FICO score, often making credit obtained more expensive than it needs to be. Below I suggest categories for inclusion in calculating your debt to income ratio to see where you stand.

Monthly Debt Payments to Consider:

- Mortgage or rent payments
- Payments on a home equity loan
- Car payments
- Student loan payments
- Minimum credit card payments times 2
- Other outstanding loan amount payments
- Child support payments

Monthly Income to Consider:

- Total net or take-home pay
- Child support or alimony payments received
- 1099 Income after taxes divided by 12
- Other monthly income

Now add up debt and income and divide.

The above list is only a guideline for gathering personal information. It may include every possible aspect of your debt/income but you may need to add categories or not use some of the categories in your calculation. If you add lines to your debt calculation do not include bills for services or products unless you have placed such bills under a payment plan such as establishing a fixed payment plan with your dentist. Under income do not include windfalls such as one time gifts, an insurance settlement, an inheritance or lottery winnings.

So now you have made the calculation. How can we answer the question how much is too much? When applying for credit, the loan officer will look at your debt to income ratio as one factor in making a decision but it will not be the only factor considered. The same debt to income ratio may be great for one family but may have a negative impact on another. Debt to interest ratios in the end are a subjective tool for loan officers to make decisions about your ability to meet a new obligation. There are some general guidelines, however, that will give you a reasonably solid picture of where you stand in the eyes of a loan officer.

30% or less is generally considered as an excellent ratio by the vast majority of loan officers

20% - 36% is a good ratio and will most likely not cause any problems with loan officers or have a negative impact on your FICO score

36% - 40% puts you on the edge of the limits of acceptability. Most lenders will ask for an explanation for why your debt to income ratio is so high. In addition, a debt to income ratio in this range begins to have a negative impact on your FICO score so lenders look to other strong numbers before making a decision to loan more money to you

40% or higher sends up red flags with lenders and your FICO score. Often, this high a ratio will be a deal killer with most lenders

By calculating your own debt to income ratio you begin to get a handle on your own financial situation. If the ratio is too high it tells you you are too deep in debt and you must do something to reduce debt. Of course, if it is very low then you need do nothing. For most lenders and the impact of debt to income on your FICO score a positive reduction in the ratio is presumed to be a sign of a healthy financial condition and goes a long way in enhancing your credit history.

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About the Author

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