1 Debt to Income (worksheet)

Your debt-to-income ratio is a personal finance measure that compares the amount of money that you earn to the amount of money that you owe to your creditors. For most people purchasing a home it is used to determine mortgage affordability.

Calculating Debt-to-Income

Calculating your debt-to-income ratio isn't hard and it doesn't cost a dime. There are two main ways to calculate this depending on the debts included in the calculation.

The less strenuous way to measure this ratio is to compare all housing debts, which includes your mortgage expense, home insurance, taxes and any other housing-related expenses. Once you have the total housing expense calculated, divide it by the amount of your gross monthly income.

Total Housing Expense

The sum of a homeowner's monthly mortgage principal and interest payments, hazard insurance premiums, property taxes and homeowner's association fees, plus monthly debt service. Monthly debt service consists of payments on credit cards, installment loans and other debts. A borrower's total housing expense is used in the calculation of a back-end ratio, which is used to qualify a borrower for a loan.

A borrower's total housing expense as a percentage of his or her total gross monthly income (the back-end ratio) generally cannot exceed 56%; however, that limit can vary slightly based on the lender, loan program and market conditions. For a borrower whose back-end ratio exceeds the limit, compensating factors such as a good credit history, a low loan-to-value ratio, and substantial net worth might be considered by underwriters in granting approval for a mortgage.

For example, if you earn $2,000 per month and have a mortgage expense of $400, taxes of $200 and insurance expenses of $150, your debt-to-income ratio is 37.5%.

The more encompassing measure is to include the total amount of money that you spend each month servicing debt. This includes all recurring debt, such as mortgages, car loans, child support payments and credit card payments.

When calculating this ratio, don't count monthly expenses such as food, entertainment and utilities.

Gross Versus Net Income

For lending purposes, the debt-to-income calculation is always based on gross income (An individual's total personal income before taking taxes or deductions into account). Gross income is a before-tax calculation. As we all know, we do get taxed, so we don't get to keep all of our gross income (in most cases). Because you can't spend money that you never receive, the result is a somewhat aggressive picture of your spending ability.

Consider the $2,000 per month gross monthly earnings example. After taxes at 2008 annual tax rates that imposed a flat rate of $802.50 plus 15% of the amount over $8,025, that $2,000 is reduced to about $1,708 or less (depending on retirement plan contributions and other factors).

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Despite the original debt-to-income calculation, you can't pay your bills with gross income, and the net income (take-home pay) is less than the number used in the calculation. That's nearly $300 that was used to help determine your spending ability but that won't actually be there to work with when it comes time to pay your bills.

Don't forget that, if you are in a higher income bracket, the percentage of your net income lost to taxes will be even higher. Regardless of your tax bracket, you'll almost certainly be better served by a more conservative approach to your debt-to-income ratio calculation. For anything other than loan eligibility, consider basing your calculations on net income rather than gross income. Using the net number provides a much more realistic picture of your ability to spend.

Good and Bad Numbers

Your debt-to-income ratio tells you a lot about the state of your financial health. Lower numbers are indicative of a better scenario because less debt is generally viewed as a good thing. After all, if you don't have debts to service, you will have more money for other things. From vacations to saving for retirement, most people can think of a million ways to spend a few extra dollars. Unfortunately, a high debt-to-income ratio often means that there aren't many extra dollars left at the end of the month.

So, what is a good ratio? Traditional lenders generally prefer a 36% debt-to-income ratio, with no more than 28% of that debt dedicated toward servicing the mortgage on your house. A debt-to-income ratio of 37-40% is often viewed as an upper limit, although some lenders will permit ratios in that range or higher.

Keep in mind that an increasing number of people are in the 41-49% range, a zone where financial trouble is imminent. Nearly all experts agree that a debt-to-income ratio above 50% is living dangerously. For many people, the best ratio is as close to 0% as possible, a number that represents debt-free living. While everyone has bills to pay and most of us have at least some recurring debt, unless your income source is unlimited and guaranteed, a lower debt-to-income ratio is almost always better than a higher ratio.

Monitoring your debt-to-income ratio is a great way to keep tabs on your expenses and your buying power. Regardless of whether you earn $25,000 a year, $100,000 a year, or $1 million a year, your debt-to-income ratio provides a snapshot of your spending habits. It's possible to have a small income yet, courtesy of good spending habits, have a low debt-to-income ratio. It's also possible to have a high income but poor spending habits, resulting in a high debt-to-income ratio. In the end, it's not how much you earn but how much you spend that makes all the difference.

*Your minimum credit card payment is not your total balance every month. It is your required minimum payment -- usually between two and three percent of the outstanding balance.

Conclusion

Keep in mind that the more debt you have the higher your ratio and the more difficult it will be to get you qualified for a loan. You and your sponsoring Advisor should use the budget worksheet to identify ways to pay down debt and maximize your debt to income ratio.

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3 Debt to Income (worksheet)

Your Gross Monthly Income: $________________________________

Other Gross Monthly Income: $________________________________

Total Gross Monthly Income: $________________________________(A)

Monthly Installment Debts: $______________

Monthly Revolving Debts: $______________

Total Monthly Debts: $______________(B)

RATIOS:

Proposed Monthly Mortgage Payment: $________________________________(C)

Top Ratio (Divide C by A): ________________________________(%)

Bottom Ratio
(Add B plus C and divide by A): ________________________________(%)

Example
In order to qualify for a mortgage for which the lender requires a debt-to-income ratio of 28/36:

- Yearly Gross Income = $45,000 / Divided by 12 = $3,750 per month income.
    - $3,750 Monthly Income x .28 = $1,050 allowed for housing expense.
    - $3,750 Monthly Income x .36 = $1,350 allowed for housing expense plus recurring debt.

Other debt cannot exceed $300 in this example. If it does, then you must pay down your recurring debt so that the balance is below $300/mo.

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