

Understanding Your Debt-to-Income Ratio

Your Debt-to-Income Ratio is a crucial personal financial health indicator. Find out how to calculate it and what it means to you.

Debt-to-income ratio is the percentage of your income you use to pay your debts. Most banks and financial professionals agree that you should keep your debt-to-income ratio at less than 36 percent of your gross income. If you want to get a picture of how your situation measures up, there's a simple way to figure it out. Take your monthly gross income—let's say two thousand dollars a month—and multiply it by 36 percent:

$$(\$2000 \times .36 = \$720)$$

In this example, your debt payments shouldn't exceed \$720 per month. It's a pretty simple formula, and it gives you a quick guideline as to how much of your income is considered a comfortable debt load.

What Does Your Ratio Mean?

Lenders use your debt-to-income ratio as an indicator of your ability to repay debt. If your ratio is low, you have a higher likelihood of repaying your debt. The higher your ratio, the more of a credit risk you become. If your debt-to-income ratio exceeds 36%, you may have trouble finding affordable credit. Keep in mind that many lenders may evaluate other circumstances and may still have loan products that will fit your personal situation.

Determine Your Debt-to-Income Ratio

Take a few minutes to determine your own debt-to-income ratio. You may need several of your recent pay stubs to determine your average monthly gross income. Remember, your gross income is your salary before any deductions or taxes are taken out. If you are paid every other week, your monthly gross income is your gross income from one paycheck times 2. You will also need several of your recent credit card statements to see what you've been paying on average each month. Finally, you will need to know what you pay for all of your other long-term recurring debt, like your mortgage payment, car payment, and other loan payments, such as school loans, home equity loans, and personal loans. You should not add in your household expenses, like utilities or grocery bills.

Now that you have the information you need, do the following:

- Review your credit card statements and determine what amount you usually pay or the average amount you pay each month.
- To that figure add your rent or mortgage, your car payments, and any other loan payments you are making.
- Divide that total by your monthly gross income.

Here is an example to assist you:

$$\text{Monthly debt-to-income ratio} = \frac{\text{Monthly Payments } \$1100}{\text{Monthly Gross Income } \$4333} = .254 \text{ or } 25.4\%$$

Now You Try It

Here is a simple worksheet you can use to enter your own monthly information. Sum up your expenses, enter your monthly gross income, and then divide the total debt by gross income to arrive at your debt-to-income ratio.

Monthly Rent or Mortgage	\$	_____
Monthly Car Payments	+ \$	_____
Monthly Other Loan Payments	+ \$	_____
Monthly Credit Card Payments	+ \$	_____
Total Debt	= \$	_____ (A)
Monthly Gross Income	\$	_____ (B)
Calculate Ratio (A / B)	=	_____ %

What Do You Do If Your Ratio Is Too High?

To improve your debt-to-income ratio, you have two options:

- Increase your income
- Lower your expenses

Increasing your income is the harder of the two tasks, but it can be done. Some ideas to consider are:

- Assess your salary in your current job. Are you getting paid market wages for the job you currently have? Can you transfer your job skills into a higher paying job?
- Take a part-time job. While this isn't feasible for everyone, it's worth thinking about. You may only need to do this for a short time to improve your debt-to-income ratio and lighten your debt load.
- Review your investments. Take a look at the rate of return you are getting on your savings accounts and investment products. Can you reallocate some of your money to higher yielding accounts?

Lowering your expenses isn't an easy task either, but it may be easier than increasing your income. There are many cost-saving measures you can take to lower your debt load. Generally, the best place to start is implementing a budget. A budget can be a first step towards [debt help](#) you make better spending decisions on your discretionary expenses. Many people can also learn to make smarter purchase decisions. Either or both of these actions may allow you to allocate more of your income to getting out of debt. You can calculate your debt-to-income ratio online with this [U.S. News and World Report debt-to-income worksheet](#). It's a good first step to getting a handle on your finances. Following the guidelines above can put you on the path to a good credit rating.