Tool 2: Determining Debt-to-Income Ratio

Sometimes people ask: “How much debt is too much?” Financial experts and lending institutions provide some guidelines on how much debt a person could handle compared to their income. Most people will likely not want to have more than 20% of their monthly paycheck going toward debt payments. Responsible lenders will base their lending decisions on these limits and may not want to give credit to people with high debt. In addition, lenders may charge you a higher interest rate for any new credit.

To figure out how much debt you have compared to your income (debt-to-income ratio), use information from your budgeting worksheet to help fill in the spaces below.

a) Total Monthly Debt Payments (include credit cards, student loans, car payments, etc. Do not include a home mortgage.) $________________________

b) Household Total Monthly Take Home (Net) Pay $________________________

c) Divide a) by b) X 100 = ____________________________ %

For example, if your total monthly debt payments equal $400 and you take home $2000 in your paycheck every month, divide $400 by $2000 = .20. To get the percent, multiply .20 x 100 = 20%. If you look in the box below, you can see that a consumer with a 20% debt limit is fully extended and might worry about future unexpected expenses.

<table>
<thead>
<tr>
<th>Percent of Consumer Debt Compared to Net Income</th>
<th>Level of debt is:</th>
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</thead>
<tbody>
<tr>
<td>10 or less</td>
<td>Probably a safe limit; borrower may feel little debt pressure.</td>
</tr>
<tr>
<td>11 to 15</td>
<td>Probably a safe limit; borrower may feel some pressure.</td>
</tr>
<tr>
<td>16 to 20</td>
<td>Fully extended; borrower may hope that no emergencies come up.</td>
</tr>
<tr>
<td>21 to 25</td>
<td>Overextended; borrower may worry about debts and making payments.</td>
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If you have a home mortgage, the percent of debt limit is different since a home is different than consumer credit. Use the formula below to include a mortgage:

a) Total Monthly Mortgage Payments (without tax & insurance) $________________________

b) Total Monthly Debt Payments (not including mortgage) $________________________

c) Add a) + b) = Total Monthly Debt/Mortgage Payments $________________________

d) Total Monthly Gross Pay (before taxes are taken out) $________________________

e) Divide c) by d) x 100 = ____________________________ %

Lenders pay attention to DTI: A review of mortgage loans approved at 50% DTI has shown a significantly higher incidence of default than those approved at 43% DTI.

Source: University of Wisconsin-Extension