msn Money

The Basics

Another financial score that can hurt you

We all know about credit scores, but there's another figure lenders watch: the debt-to-income ratio. It's a good indicator of your financial well-being.

By Bankrate.com

By now you know your three-digit credit, or FICO, score is a very important number in your financial life, but did you know there's also a two-digit number that can be just as significant?

It's your debt-to-income ratio, and it can shed a light on, and help you better understand, your true financial picture.

The good news is, getting this number doesn't cost you a penny, and it can be calculated in just a few minutes at your kitchen table.

So, if you think getting insight into your financial life requires sifting through your retirement investments, reading through every fund prospectus and tallying your expenses to the penny, think again.

It's true that nitty-gritty details can make a difference, but you can get a fairly accurate understanding of your financial picture by spending just a minute or two calculating your debt-to-income, or DTI, ratio. By knowing the ratio -- and how to improve it -- you can increase your chances of getting a better mortgage, a better car loan and even better credit card rates.

Start with a list

Your debt-to-income ratio is exactly what it sounds like: the amount of debt you have in the form of mortgages, car loans, student loans and credit card debt, as compared to your overall income.

To calculate your overall DTI ratio, sometimes known as a back-end ratio, add up all of your monthly debt obligations -- often called recurring debt. Include your mortgage (principal, interest, taxes and insurance) and home equity loan payments, car loans, student loans, your minimum monthly payments on any credit card debt, and any other loans that you might have. Do not include expenses such as groceries, utilities and gas. Take this total and divide it by your gross monthly income from all sources. If you're not good at long division or don't have a calculator handy, go to Bankrate's calculator section to use our debt-to-income ratio calculator.

Some lenders will exclude the mortgage payment from this equation, but they lower the acceptable ratio for receiving a loan. The concept is the same: It measures your debt load in comparison to your income.

Let's say you and your spouse together earn $83,000 per year, or $6,916 per month. Your total mortgage payment is $1,350, your car loans total $365, your minimum credit card payments are $250, and your student loans add up to $300. That equals a recurring debt of $2,265 a month. Divide the $2,265 by $6,916 and you'll find your DTI is 32.75%.

In general, you'll want to keep that number below 36% -- a threshold that loan officers and credit card issuers often use as a factor when they determine how much they're willing to lend you. "If you go higher than 36%, you are on a slippery slope," says Diane McCurdy, a certified financial planner and the author of "How Much Is Enough?" Lenders might give you money, she adds, "but they'll give you higher interest rates, and if anything goes awry, they'll sock it to you."

So why is that number so important? It's all about proportion, says Laura Russell, a certified financial counselor with GreenPath Debt Solutions. "You can be making a lot of money every month, but if you've got the debt to match it, that can be a problem," she says. "It's important not to overextend yourself." The higher your number, the riskier it is for lenders to offer you loans -- and the more they'll make you pay for them.

Finding leverage

Though debt-to-income ratios don't have the kind of buzz that FICO scores do, they can play a key role in determining if you qualify for a loan and how much you can get. "Your debt-to-income ratio is one of the tools that banks will use to determine whether they'll lend you money for a mortgage, a car loan or a student loan," says Dave Hinnenkamp, the CEO of **KDV Wealth** Management.

While other factors, such as your FICO score and length of time in your home or job, will come into play into this equation, a good debt-to-income ratio can give you leverage to negotiate if other factors aren't in your favor. "The stronger you are financially, the more leverage you have when negotiating interest rates or loan amounts," says Hinnenkamp. "So there is an advantage to keeping that ratio low."

The DTI ratio is something lenders look at in addition to your credit score. Remember, your FICO score reflects only your payment history and does not have anything to do with your income. You can have a very high FICO score with very little income. Conversely, you can have very high income and a very low FICO score. That's why lenders use both.

To be sure you're on solid ground, McCurdy recommends trying to bring your overall DTI ratio to 30% or below. After all, you have plenty of other financial obligations, from groceries and utilities to restaurants and entertainment. "You never know when you're

going to have an emergency," she says. "You don't want to get in trouble -- and potentially lose your home or car."

Cutting your ratio

Reducing your debt-to-income ratio can be challenging, since these financial obligations are, by definition, ongoing. But there are tactics you can use to start addressing the problem, says McCurdy. "Look at where your cash is going," she says. "Ask yourself where you can cut back."

- **Find areas to cut costs.** After you've looked at your budget and done some cost-cutting, take the money you've saved and put it into your highest-interest loans and debts -- most likely your credit cards.

- **Double up on credit cards.** McCurdy recommends at least doubling your minimum payment to start chipping away at your debt-to-income ratio. If credit cards aren't the problem, you can also pay more on any other loan, as long as there are no prepayment penalties.

- **Stop charging.** Once you've started making progress, make sure you don't rack up more credit card debt.

- **Build an emergency fund.** Have this money so you can replace your furnace or pay off a vacation without going back into credit card debt.

- **Avoid major purchases.** If you're teetering on the edge of problems, it might be wise to hold off on major purchases. "Don't overextend yourself with a new car loan or mortgage loan," Russell says.

- **Consider getting help.** If you still can't rein in your DTI ratio, you may need to get the help of a financial adviser who can help you consolidate loans and put you on the right track.

Another ratio

There's also a second, related ratio that's helpful if you want to judge whether you can afford to buy a certain house or if you want to know you can still afford to live in your existing home. Perhaps your income has dropped or expenses have changed significantly because of a new, higher interest rate, new tax increase or skyrocketing insurance costs. This figure is called the front-end ratio and you can calculate it by adding up the monthly mortgage principal, interest, taxes and insurance, and dividing it by your gross income. That number generally should be no more than 28%, says Russell. "You might see exceptions for a first-time homebuyer or someone with marginal credit, but in general, you don't want to go above that," she says.

Keeping your front-end and back-end ratios in check will help you stay financially stable. If you find yourself edging into dangerous territory, McCurdy recommends cutting back on spending for entertainment and restaurants, paying more than the minimum payment on your credit cards and tackling your highest-rate loans and credit card debts first.
Even if your numbers fit within the prescribed ratios, be sure that they make sense for you. "We're always being lured by advertising to buy these wonderful things," says McCurdy, "but just because you qualify for something doesn't mean you're managing your money well. If you take everything to the limit, you don't leave much room for error."

This article was reported and written by Erin Peterson for Bankrate.com.

Published Feb. 15, 2007