Homebuying 101:

Debt to Income Ratio

The debt-to-income ratio is, simply, the way that mortgage lenders decide how much money you can comfortably afford to borrow. It is the percentage of your monthly gross income (before taxes) that is used to pay your monthly debts (not your monthly living expenses). Two calculations are involved, a front ratio and a back ratio, written in ratio form, i.e., 33/38.

The first number indicates the percentage of your monthly gross income used to pay housing costs, such as principal, interest, taxes, insurance, mortgage insurance and homeowners' association dues. The second number indicates your monthly consumer debt, such as car payments, credit card debt, installment loans, etc. Other living expenses are not considered debt.

So a debt-to-income ratio of 33/38 means that 33 percent of your monthly gross income is used to pay your monthly housing costs, and 5 percent of your monthly gross income is used to pay your consumer debt - so your housing costs plus your consumer debt equals 38 percent.

33/38 is a common guideline for debt-to-income ratios. Depending on your down payment and credit score, the guidelines can be looser or tighter, and guidelines also vary according to program. The FHA, for instance, requires no better than a 29/41 qualifying ratio, while the VA guidelines require no front ratio but a back ratio of 41.

What if you already have a house or don't plan to buy a house for a good period of time? You still need to know and control your debt-to-income ratio so you can avoid creeping indebtedness, or the gradual rising of debt. Impulse buying and routine use of credit cards for small, daily purchases can easily lead to unmanageable debt.

Debt-to-income ratio not only affects your ability to buy a home, but other purchases as well. Debt-to-income ratios are powerful indicators of creditworthiness and financial health. Know your ratio and keep it low. Your consumer-debt number should never go higher than 20 percent regardless. If you let it rise above 20 percent, you may:

- *jeopardize your ability to make major purchases: cars, homes, and major appliances.*

- *not get the lowest possible interest rates and best credit terms. have difficulty getting additional credit in emergencies.*

If you keep a stranglehold on your spending habits and therefore your debt-to-income ratio, you can: make sound buying decisions, and refrain from frivolous credit purchases and loans.

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