Understanding Your Debt to Income Ratio

When developing your debt reduction plan or seeking new credit for a large purchase, you must determine not only how much debt you can afford on a monthly basis, but a safe level of debt dependant upon your income level. There are no black-and-white guidelines to follow for this purpose, but there are a few points to take note of before taking any action that affects the level of your debt.

Every credit card offer you receive in the mail is based on complicated computations considering your credit history, current interest rates and any past defaults. Any granting of credit is based on whether the lender considers you a good calculated risk for repayment.

When applying for credit, you need to consider your personal situation with a little more care and control. You are likely to be much more conservative than the credit card companies, but will put you in a better position in the long term.

Besides factoring in the estimated payments into your monthly budget, you need to consider your net worth and long-term wealth building. This means that your assets should always exceed the amount you owe to creditors, including your home and auto.

If you have a negative net worth, this is not good! Obviously, the larger your net worth is, the more comfortable you will be able to live on a daily basis and in the future.

The other reason this number is important is that if you should lose your income or fall on hard times, you will still be able to sell all of your assets to pay existing creditors. Although you may not be left with much, you will still be in the black and not have to file for bankruptcy – always the best option!

Some experts suggest that your debt to income ratio should never exceed 1:2. This number, however, would exclude your mortgage or auto loan; it is assumed that these debts are less than what the security is actually worth should you need to sell it.

This means that if you have student loans and credit card balances, the total of these should not exceed 50% of your annual income. If you make $50,000 per year, your outstanding balances on these types of debt should be less than $25,000.

On the same note, consider this number before ever applying for new credit or a new loan. If you are already at the 1:2 ratio level, pursuing additional loans is not advised until some of the existing debt is paid down. This will increase your chances of being approved, the likelihood that you can pay the debt, and result in a lower overall interest rate.

Using these considerations can significantly reduce your impulse buying habits that result in high credit card balances and added hardship in the future. When considering buying an item, it's best to force yourself to wait for a week or two before moving forward. If you find that you stop thinking about it or find something else you'd rather have, you probably never needed it in the first place!