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Understanding the Debt-to-Income Ratio and Its Importance to Lenders

If you are thinking about purchasing this year, it is possible that you will need a home loan to complete the purchase. During the process of obtaining a home loan, you will hear many terms that you may not be familiar with. I asked **Jaxzann Riggs**, owner of **The Mortgage Network** to explain one of the terms that you will hear… the **Debt-to-Income Ratio (DTI).**

Let's Talk Home Financing

By JIM SMITH Realtor®

The "Debt" component in the DTI is the total of the monthly payment for any installment loans (mortgage, auto loan, student loans, etc.) and the minimum monthly payment for any revolving accounts (credit cards, store charge accounts, etc.). If you make any alimony or child support payments, those are included as well. Lastly, add in your new home's mortgage expense (principal, interest, insurance, and taxes) to find your total debt.

The "Income" factor is your monthly gross income. While this is straightforward to calculate for salaried W2 employees, it can get complicated when your pay may vary month to month.

DTI is calculated by dividing your debt by your income. As an example, monthly debt of $4,000 divided by monthly income of $9,000 would be a 44% DTI.

Qualifying Ratios: Different loan products have different qualifying DTI ratios. For the standard conventional mortgage, it's best to have a DTI of less than 45%. A DTI of up to 50% can be allowed based on other factors like high credit score\ or large cash reserves. FHA loans allow for a higher DTI, up to 56% in some cases.

How to Lower DTI Ratio: Dollar for dollar, lowering debt makes a bigger impact on your DTI than increasing income. If you can pay down debts, look for the accounts with a low balance and a high monthly payment. Accounts with a zero balance are not included in your DTI. Since the average auto loan is often more than $500/month, if you can afford to pay it off you can dramatically improve your ratio. Consolidating your debt can improve your DTI as well. For example, someone with eight in-store credit cards that all have small balances is getting hit with eight minimum payment charges. If they consolidate to one credit card with a higher limit, they will only have one minimum payment showing in their total monthly debt factor.

Other Tips: Sometimes there are accounts that show on your credit report that someone else makes the payment on, such as being an authorized user or co-signer on an account someone else pays. If you can document a 12-month history of payments coming from the other person's account, you can omit the payment from your DTI ratio. Student loans are included in your DTI even when you aren't required to make payments currently, but the amount can vary by loan product. Installment loans (e.g., auto and student) with 10 or fewer payments can possibly be omitted from your DTI ratio as well.

Reducing the proposed monthly payment on the new property improves your DTI ratio. The interest rate charged on your loan is far more impactful on DTI ratios than making a larger down payment (unless the larger down payment eliminates monthly mortgage insurance).

This strategy is referred to as "buying down" the interest rate, and Jaxzann can help you determine when and how that option makes sense.

Improving your DTI can take time, so even if you don't plan to buy this year, it is wise to speak with a mortgage professional now.

Jaxzann brings over 30 years of experience to each application that she and her team handle. Reach her on her cell phone at **303-990-2992** with your questions.