DEBT RATIOS

When analyzing the personal budget of a borrower, lenders use two different debt ratios to determine if the borrower can afford his obligations. The debt ratio is used primarily in underwriting personal loans or residential loans. These two debt ratios are:

1. Top Debt Ratio

2. Bottom Debt Ratio

The "top" debt ratio is defined as:

$$\text{Top Debt Ratio} = \frac{\text{Monthly Housing Expense}}{\text{Gross Monthly Income}}$$

By "total housing expense" we mean either the borrower's monthly rent payments, or if he owns his own *home* (virtually all our borrowers do own their own homes), the total of the following –

Monthly Housing Expense = 1st mortgage payment on his home plus

Real estate taxes (annual cast/12) plus

Insurance (annual cost/12) plus

Homeowner's association dues (if his home is a condo or townhouse) plus Second mortgage payment (if any) plus Third mortgage payment (if any).

You will often hear the term P.I.T.I. It refers to (P)rincipal, (I)nterest, (T)axes and (I)nsurance. While P.I.T.I. is not exactly the same as Total Housing Expense because it does not include homeowner's association dues, the two terms are often used interchangeably.

Lenders have learned over the years that a borrower's "top" debt ratio should not exceed 25%. In other words, a person's housing expense should not exceed ¼ of their income. While lenders will often stretch this number to as high as 28%, traditional lending theory maintains that anyone with a debt ratio in excess of .25% stands a good chance of developing budget problems. Given Lenders have set these standards, many lenders today have loosened up on their standards allowing higher ratios in order to close loans.

The second ratio that lenders use to determine if a borrower can afford his obligations is the "bottom" debt ratio. It is defined as follows:

$$\text{Bottom Debt Ratio} = \frac{\text{Total Housing Expense + Debt Payments}}{\text{Gross Monthly Income}}$$

Debt Ratios

The only difference between the two ratios is the inclusion in the numerator of "debt payments." Debt payments include the following:

Debt Payments =
- Car payments
- Charge card payments
- Payments on installment loans, for example – a payment on a washer & dryer that the borrower purchased
- Payments on personal loans, for example –signature loan from the borrower's bank

What is <u>not</u> included in "debt payments" are –

- Utilities (power, water or telephone)
- Payments on real estate loans

Real estate loans are usually offset first by the net rental income from the property. If the borrower has a net positive cash flow from all his rentals, then the net income is usually added to his "gross monthly income." If the borrower has a net negative cash flow from all of his rental properties, then the amount of the negative cash flow is usually added to the numerator of *the* "bottom" debt ratio as if it were a monthly debt obligation, like a car payment.

Traditional lending theory maintains that a borrower's "bottom" debt ratio should not exceed 33 1/3%. In other words, the total of the borrower's housing expense and debt obligations should not exceed 1/3 of his income. Lenders often will stretch this ratio to as high as 36%, and some have even been known to stretch as high as 40% or more. Obviously a loan with a debt ratio of 40% is a far more risky loan than a loan with a debt ratio of 32%.