Debt Service Ratio versus Debt Safety Ratio

What are your debt service ratio and your debt safety ratio?

The debt service ratio and debt safety ratio are tools designed to gauge your ability to repay debt. Both the debt service ratio and the debt safety ratio compare your loan obligation to your monthly income. Your debt service ratio compares your total monthly loan payments to your gross monthly income, while your debt safety ratio compares your monthly consumer debt payments to your monthly take-home pay. These are important calculations for two reasons. First, keeping your debt service ratio and debt safety ratio at manageable levels should prevent you from taking on more debt than you can handle. Second, loan officers typically use similar formulas to determine whether you qualify for a mortgage, car loan, and credit card.

How do you calculate your debt service ratio?

As mentioned above, your debt service ratio compares your total monthly loan payments to your gross monthly income (your total income, including taxes and pretax deductions). This ratio ignores current liabilities (such as insurance premiums and utility payments) and takes into account only debt obligations, such as your mortgage, installment, and personal obligations that will not be paid off by minimum required payments within the next 10 months. The formula for debt service ratio is as follows:

Debt service ratio = Total monthly loan payments / Monthly gross income

Example(s):*Say you have a $1,200 monthly mortgage payment, a $200 auto loan payment, $250 in credit card payments, and a $100 student loan payment. This puts your total monthly loan payments at $1,750. If your monthly gross income is $6,500, you would have a debt service ratio of 27 percent ($1,750 / $6,500 =.27 = 27 percent).*

How do you calculate your debt safety ratio?

As mentioned above, your debt safety ratio compares your monthly consumer debt payments to your monthly take-home income (after-tax income, plus your voluntary pretax or after-tax deductions). This ratio ignores such current liabilities as insurance premiums and utility payments, and it also excludes your monthly mortgage obligation. Only installment, personal loan, and revolving credit payments are used in the calculation. The formula for debt safety ratio is as follows:

Debt safety ratio = Monthly consumer credit payments / Monthly take-home pay

Example(s):*Using the facts from the example above, your monthly consumer credit payments (excluding mortgage payment) would be $550. Assume your monthly take-home pay would be about $4,500. This would give you a debt safety ratio of about 12 percent ($550 / $4,500 =.12 = 12 percent).*

What are the acceptable levels for debt service ratio and debt safety ratio?

Most advisors suggest your debt service ratio should be no more than 35 percent and should preferably be around 25 percent. Your debt safety ratio should not exceed 20 percent and should preferably be around 15 percent. Those most successful financially are able to get the debt safety ratio and the debt service ratio to 0 percent by the time they retire. Lending institutions may have more lenient or more stringent standards, depending on the type of loan for which you are applying, your credit history, and other factors.

Contact Us Today!

309-966-1425

office@claritygroupmw.com

www.claritygroupmw.com

2515 E Washington St.
East Peoria, IL 61611
or
4302 W. Crystal Lake Rd
Suite C McHenry, IL 60050

Call us or visit us online to schedule a free financial check up!

Securities and advisory services offered through Ausdal Financial Partners, Inc., memberFINRA/SIPC. 5187 Utica Ridge Rd., Davenport, IA 52807. 563-326-2064.WWW.AUSDAL.COM.

Ausdal Financial Partners, Inc. and Clarity Group Midwest are separately owned and operated.

Prepared by Broadridge Investor Communication Solutions, Inc. Copyright 2024