What Is a Debt to Income Ratio and Why Is It Important?

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One of the key numbers a lender will use to determine your mortgage is your debt-to-income ratio (DTI). This number tells them how much you can afford to pay each month towards your mortgage, based on your monthly expenses.

But what, exactly, is a debt-to-income ratio? Let’s look at what DTI is and why it’s important in buying a home.

What is a debt to income ratio?

Your DTI is a comparison of your monthly income and expenditures. It creates a nice, neat ratio that shows lenders what you can afford to spend on a mortgage.

All of your recurring expenses will figure into your DTI. This includes regular bills, car payments, credit card payments, and anything else you're responsible for on a regular basis.

The same goes for your income. Include all your income sources, no matter how small, in your calculation of your DTI.

Why is DTI important?

First, let's point out that DTI is not used in your credit report. Therefore, you likely won't see this number reported anywhere until you apply for a mortgage.

Lenders use DTI to determine how much you can afford to add to your monthly expenses. This gives them a picture of what your monthly finances look like and whether or not you will be able to repay the loan.

If you have a low DTI, you can comfortably add more debt to your monthly expenses without concern. However, if you have a high DTI, taking on additional expenses may make it difficult for you to pay them back. Lenders consider that higher DTI a risk.

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What is a good debt to income ratio?

Generally, to qualify for any mortgage you will need to have a DTI of no more than 43%. However, the lower that number the better. Most lenders prefer your debt-to-income ratio be below 36%.

It does get more complicated, though. There are actually two DTI separate figures. Which one gets used depends on the lender.

1. Front-end DTIs — These ratios are limited to how much of your income goes towards housing costs. It includes only housing-related expenses like mortgage payments, property taxes and insurance.

2. Back-end DTIs — These numbers include all your debt. In addition to housing costs, it includes things like minimum credit card payments, student loans and auto loans.

If you want to apply for a mortgage, most lenders want you to have a front-end DTI less than 28%. If you instead want to qualify for an FHA loan, you will need a front-end ratio lower than 31%.

How to Calculate Your DTI

To calculate your DTI, you will need to accurately assess how much you make and how much you spend each month. Simply divide your calculated monthly expenses by your monthly income.

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Here's how it breaks down. Let's say you have $3,500 in monthly recurring expenses. Of that, $2,000 goes to housing costs — mortgage, insurance and property tax. The additional $1,500 a month comes from debts like auto loans and credit card payments.

Now, let's say your monthly income is $5,500. To get your front-end DTI, you would divide 2,000 (housing costs) by 5,500 (monthly income) and get .365. That means, in this case, your front-end DTI would be 36.5%.

To calculate your back-end DTI, you would include your other debts with your housing costs. In this case, you would divide 3,500 (monthly recurring expenses) by 5,500 (monthly income) and get .63. This means your back-end DTI is 63%.

Overall, your debt-to-income ratio is one of the most important factors when you're shopping for a mortgage. Remember — most lenders look for a 36% DTI or lower. Lowering your DTI will help you get the best rates on the market.

But what if you have trouble lowering your DTI? A qualified mortgage broker can help you develop strategies to put you in a position to get the mortgage you'll want.

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