

Debt-to-Income Ratio

Do you have too much bad debt?

Look at your total bad debt — not your interest payments, but the debts themselves — and compare this number to your annual after-tax income. Here's how you do that:

Example:

Total bad debt:

Total after-tax annual income:

Bad debt-to-income ratio:
 $(\$6,437 \div \$30,000) =$

Danger, Will Robinson! A 21.4% bad debt-to-income ratio is awfully high, especially if it's all — or mostly — credit cards and charge cards.

The ideal number here is zero, but at the very least you want to keep bad debt — including car loans — to 15% or less of your after-tax income. Otherwise, your debt payments will eat up too big a chunk of your paycheck. Sure, some banks will advise you to go well beyond 15%, but remember who profits if you stay on the debtor side of the divide — they do!

Ready? It's your turn:

My Total bad debt:

My Total after-tax annual income:

My Bad debt-to-income ratio:
 $\$ \underline{\hspace{2cm}} \div \$ \underline{\hspace{2cm}} =$

If you've been reading other financial advice, you may think we've made a mistake. A common suggestion is to divide your after-tax income by your annual debt payments (the money you have to come up with just to pay the mortgage, other loan payments, and credit card minimums). Because we're aiming to get you out of debt — not to just leave you afloat so that you remain enslaved to the bankers — we're doing two things differently:

1. We're leaving good debt out of the equation. It's tougher to give a rule of thumb for the whole ball of wax. Suffice it to say that if you're having trouble just paying the minimums — you're not regularly saving or paying down debt — you've got too much debt period, good or bad.

2. We're dividing your after-tax income by total bad debt because we want to focus on eliminating all of the bad debt as quickly as possible, not just keeping up with the payments.

Your key takeaway here is that your bad debt-to-income ratio needs to head toward zero.