Debt-to-Income Ratios: What They Are, How They Are Calculated, And How To Lower Yours

Every mortgage loan available requires some sort of income verification and debt ratio calculations. This is a good thing because it ensures that homebuyers can actually make their mortgage payments.

In the pre-mortgage meltdown world, income and debt verifications were basically nonexistent. This led to anybody being able to get a loan, which resulted in a lot of people not being able to pay their mortgages and having their homes foreclosed on.

Lending standards are much more strict today to prevent another housing market crisis. Before you can qualify for a mortgage, your lender will look at your financial profile to determine how much you can afford to borrow for a home loan. This is done by calculating your **debt-to-income ratios.**

This article should help you understand what debt-to-income ratios are, how they are calculated, and how you can lower yours to qualify for a mortgage.

The Two Types of Debt Ratios

There are two types of debt to income calculations that lenders use to determine how much you can afford to borrow for a home loan: **front-end** and **back-end.**

Each ratio offers a comparison of your current debt amounts to your gross monthly income. There are typically maximum percentage limits for each that lenders do not exceed unless you make a high down payment or have significant assets.

Front-End Debt Ratio (Mortgage-to-Income Ratio)

Your front-end debt ratio can also be called your mortgage-to-income ratio. This debt ratio consists of ONLY the projected monthly mortgage payment divided by your gross monthly income.

A typical monthly mortgage includes the principal, interest, taxes and insurance, and HOA dues. If your projected mortgage payment for all of this was **$2,000** and your monthly income is **$8,000**, your front-end debt ratio would be **25 percent.**

Back-End Debt Ratio (Total Debt-To-Income Ratio)

Your back-end debt ratio is your basic debt-to-income ratio. It includes your entire mortgage payment and ALL consumer debt payments (cars, student loans, credit cards) divided your gross monthly income.

If your projected monthly mortgage payment is **$2,000** , your monthly liabilities are **$1,500**, and your monthly income is **$8,000**, your back-end debt ratio would be around **44 percent.**

Maximum Allowable Debt Ratios

Because it includes all of your monthly debt expenses, most lenders will put more focus on your back-end debt ratio to determine what size mortgage you can afford.

The maximum allowable debt-to-income ratios vary by lender, mortgage program, loan type, credit score, and loan-to-value (LTV) ratio. However, most programs and lenders apply a maximum debt-to-income ratio of **43% to 50%.**

- Conventional Loans = 45%
- FHA loans = 43%
- VA loans = 41%
- Jumbo loans = 41-45%
- Physician loans = 43-50%

Occasionally a lender will take into account both the back-end and front-end ratio. If they do, they will typically allow a maximum front-end ratio of **33%.**

10 Ways To Lower Your Debt Ratios

With interest rates and home prices rising, high debt ratios are becoming an issue for many borrowers. Luckily, there are a few ways you can lower your debt ratios if you are struggling to qualify for a home loan.

1. Put less money down

If you are planning on putting more than the minimum toward your down payment, consider using those funds to pay off consumer debt and lower your monthly liabilities.

2. Find a co-signer

Adding a co-signer onto your loan will increase the income your lender uses to calculate your debt ratio. Some loan programs, like FHA and Conventional lenders, will even allow for non-occupant co-signers.

3. Consider an Adjustable Rate Mortgage

Adjustable Rate Mortgages typically have lower rates than 30-year fixed loans. This would lower your projected mortgage payment, thus lowering your debt ratio.

4. Buy down the interest rate

Another option to lower your interest rate is to buy down the rate by paying points. However, this might not be wise if rates are expected to drop in the next few years and you could get an even lower rate through a refinance.

5. Pay down installment loans to 10 months remaining

For conventional loans, lenders are allowed to omit installment debt when calculating debt ratios if there are 10 or fewer payments left on the account.

6. Garner gift funds

If you do not have extra funds available to lower your consumer debt, consider asking for gift funds from a friend or family member.

7. Gross up non-taxable income (like Social Security income or Child Support)

In most cases, lenders can "gross up" non-taxable income by 125% for Conventional loans and 115% for FHA loans for qualifying purposes. For example, if you get $1,000 per month in Social Security income, Fannie Mae will consider it $1,250 per month in most cases (1.25 x $1,000).

8. Switch to an FHA or Non-QM loan.

This does not "lower" debt ratios per se, but it does provide for more flexibility. This is because FHA financing is far more flexible than Conventional (Fannie Mae or Freddie Mac) financing when it comes to debt ratios. Non-QM loans offer another alternative, where rents or bank statements can be used for income (these loans typically come with higher rates, however).

9. Use Financed Single Payment PMI

Private Mortgage Insurance (PMI) payments for a $500,000 loan at 90% loan-to-value can add $200 or more to a monthly housing payment. That payment can be eliminated by paying for PMI upfront with a single payment (at a cost of about 1.5% of the loan amount, depending on your credit score). Lenders can help pay for that with a lender credit or by financing the payment with a larger loan.

10. Refinance your consumer loans

If you are in good standing with your creditors, you may have the option to refinance car loans or student loans to lower your monthly payment – by lowering the rate, extending the term or simply re-amortizing the remaining principal. If you have a spouse who does not need to be on your mortgage, you can also potentially refinance these loans into their name and remove them from your debt calculation altogether.

Conclusion

For those considering applying for mortgage financing, understanding what debt ratios are and how they are calculated is crucial. Knowing this will help you be able to take action to lower your debt ratio so you can qualify for the best loan terms.

If you are struggling to qualify for a mortgage because of high debt ratios, fill out the form below to speak with one of our mortgage advisors. They will be able to help you put a plan in place to either lower your debt ratio or explore other loan options.

Want to learn more? Please schedule a call today!

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