CONSUMER COUNCIL OF FIJI

FINANCIAL SERVICES

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UNDERSTANDING THE DEBT-TO-INCOME RATIO

What is the debt-to-income ratio?

The debt-to-income ratio (DTI) is one way in which credit providers measure your ability to make repayments on a loan, once it is approved. It is the portion of your income that is available to pay for your debts because you also need money for other living expenses.

Why is the debt-to-income (DTI) ratio so important?

The DTI ratio is important because it shows the credit provider (and even yourself) your ability to repay your loans without facing any difficulties.

So how do I find out my DTI ratio?

The bank/credit provider will calculate your DTI ratio when you are applying for a loan. However, it is advisable that you do this yourself before going to the bank. The ratio is calculated using a simple formula: Take the total amount of money you are spending on repaying your debts, divide that by your total net income and then multiply the result by 100. The final figure should be taken as a percentage. The following is an illustration of the formula:

How to calculate a DTI ratio

$$\frac{(\text{ monthly debt payments })}{(\text{ net monthly income })} \times 100$$

The following is a simple example of how one can calculate DTI ratio:

> John is already paying $200 per month for his home loan and $50 for a hire purchase account. So, his total fixed debt repayment per month is $250 ($200 + $50). Let's say John's net income is $500 per fortnight or $1,000 a month. His DTI ratio would then be ($250 ÷ $1,000) x 100 = 25%. Hence, his DTI is 25%.

What does this mean?

This means that 25 cents out of every dollar that John earns, goes towards repaying his debts. The remaining 75% of his pay is available for him to use on living expenses or to takeout the new loan he is applying for. It is very important to take into account all the daily living expenses that also need to be paid from this remaining 75%.

How to know whether you are in the safe zone?

A low debt-to-income ratio shows there is a good balance between your debts and your income.

BE A RESPONSIBLE BORROWER – Do not borrow more than what you can afford!

However, a high DTI ratio means your debt levels are high in relation to what you earn and therefore, you could have trouble with your repayments.

So what is a safe DTI ratio?

A common DTI benchmark for most banks and creditors is around 30% to 40%. In our example, John's DTI ratio is 25%. That puts it within the recommended DTI which means it is safe for John to take out the loan.

What is not a good DTI ratio?

When the DTI ratio is high, your ability to make repayments is poor and the chances of you defaulting (not making repayments) are higher. If you borrow further with a high DTI, you risk having your hire purchase goods or even your house repossessed by the bank or credit provider.

The following example shows what a bad DTI ratio is:

> Mary is married with two children. She is employed as a senior clerk at a Government department. Mary decided to apply for a personal unsecured loan of $2000 from her bank for a trip to Australia. She already has an existing personal unsecured loan with her bank for which $267 is deducted from her fortnightly pay. She is also paying $60 per fortnight for a smart phone and another $70 for a flat screen TV she bought during Christmas. Her total debt repayment every month comes to $794. Her total monthly

net salary is $1080. So her DTI is ($794 ÷ $1080) x 100 = 73.52%. This is well above the recommended 30% to 40% considered to be within the safe zone.

Mary is hoping that her loans officer will approve her loan. Currently, however, for every dollar she earns per month, about 74 cents is used to repay her existing debts. Her husband, who has a similar salary level, is already in the same situation as most of his salary is going towards repaying their home loan. Mary and her husband have to live with a tight budget of $450 per month to pay for daily living expenses such as electricity and water bills, food, bus fares, medical expenses, etc. If her loan is approved, her repayments will increase significantly and the family will be left with even lesser cash for their daily expenses.

Have you checked your DTI lately?

If my DTI ratio is above the recommend range, what should I do?

You should simply avoid taking further loan. First clear your current debts if you wish to borrow more. You can also use your hobby to make some money to ease your financial situation.

What if my loans officer says it is okay to borrow with my high DTI ratio?

Be careful about loans officers who may try to convince you to take out loans. The banks/credit providers also need to be responsible when giving out loans. As a golden rule,they must give proper consideration to your DTI ratio and ability to repay your loans. Remember, it is YOU and not the loans officer or the bank that will be doing the repayments!

The bank's calculation of my DTI ratio is lower than my own calculation. What should I do then?

It is important that you analyse your own DTI ratio before engaging in any borrowing. Remember, you are the one who will be paying off the loan. You know your financial situation better than anyone else. The bank or credit provider really doesn't know your spending habits such as the frequency of eating out or going to the movies, etc. No matter what information/documents you provide to the bank or credit provider to assess your loan application, he/she never really is able to get the complete picture of your financial situation.

How often should I calculate my DTI ratio?

You can calculate your DTI regularly to check your financial status if you intend to take more loan.

Beware of irresponsible lenders!

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