Home Equity Loan Basics

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Understanding your debt-to-income ratio

Your debt-to-income ratio (or DTI) will play an important part in home equity lines of credit. But what is it exactly? Simply put, it is the percentage of your monthly income that is taken up by your monthly debt payments.

(1)

Lenders look at your existing debt payments plus the projected payment for the new loan, and then calculate what percentage that represents of your total pre-tax income. This percentage is your debt-to-income ratio, which is one of the factors lenders use to decide whether or not to extend you a loan. Generally, the lower your debt-to-income ratio is, the more likely you are to qualify.

How to calculate it

Lenders calculate your debt-to-income ratio by using these steps:

(2)

1. Add up your existing monthly mortgage payment (including taxes, insurance and any homeowners association or condo dues, if applicable) plus debt such as credit cards, car loans and leases, or student loans. Don't include utility payments like phone, water and electric bills or living expenses like grocery bills.
2. Add your projected future home equity loan or line of credit payment to your debt total from step 1. (3)
3. Divide that total number by your monthly pre-tax income. The resulting percentage is your debt-to-income ratio.

For example, if your monthly income is $6,500 and your monthly debts plus your monthly projected home equity line of credit payment are $2,340, your debt-to-income ratio would be 36%.

Lowering your debt-to-income ratio

(4)

Most lenders will want your debt--to-income ratio to be no more than 36%, but some lenders or loan products may require a lower percentage in order to qualify.

If your DTI ratio is too high, consider how you can lower it. You might be able to pay down your credit cards or reduce other monthly debts. By understanding what your debt picture looks like, you can develop a plan to tackle it.

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