

FINANCIAL PLANNING BUILDING BLOCKS

Have you ever wondered whether you were carrying too much debt? Are you thinking about buying a house or car? If you are, then the loan officer definitely will be concerned with your debt level.

Using debt is one way in which consumers are able to achieve financial goals. Of course, there is a cost to debt – interest and fees, which can negatively affect your financial situation. Proper use of debt can be beneficial, but let debt get out of control, and your financial future can turn dark in a hurry.

Debt can be either short-term or long-term. Short-term, or consumer debt, is what you use to purchase products and services. Some examples of consumer debt include credit card debt, auto loans, and personal lines of credit. The most common form of long-term debt is a home mortgage. There are many types of home mortgage available, and determining which one might be right for you can take a lot of research and evaluation.

Here are some rules of thumb you can use (and that lending institutions do use) to determine if you are carrying too much debt.

- Monthly housing costs (including principal, interest, taxes, fees, and insurance) should be no more than 28% of your gross income (that's before taxes).
- Total monthly payment on all debts should be no more than 36% of gross monthly income. This includes both consumer debt and mortgages.
- Total consumer debt should not exceed 20% of your net income (after deducting taxes).

To do the calculations, add up your monthly debt payments, then divide that amount by your monthly income (remember to use either gross or net income as appropriate). For example, if you have total monthly debt payments of \$2,000 and a gross monthly income of \$3,000, your total debt payments equal about 67% of your income. To stay within the 36% ratio, you should reduce debt payments to no more than \$1,080.

How did you do? If your debt levels are good, congratulations! You have the start of a solid financial foundation. Debt levels too high? Don't despair, but begin a plan to gradually reduce your debt exposure – and be careful about adding more debt to the picture. It may take time, but you can do it!

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