Debt load

What is debt load?

Debt load is a term that is used to describe a consumer’s amount of debt. It is often used to understand if you are carrying a “safe” amount of credit. Creditors look at a debt-income ratio, comparing your income with your outgo to analyze whether you have too much debt. The debt-income ratio is figured monthly and reveals either how good or bad your financial picture is on a day-to-day basis.

You can figure this ratio for yourself. Add all of your non-housing monthly payments, except for your utilities and loans. Then compare that total with your total gross annual wages divided by 12. If you don’t have fixed monthly payments on revolving debts such as credit cards, you can estimate your monthly payments at 4% of the total amount you owe. When you divide your monthly debt payments by your total monthly income, you will get your monthly debt-to-income ratio. It is usually expressed as a percentage, so move the decimal point two places to the right.

Example:
- Gross monthly income is $2,000
- Monthly debt is $500 (credit card payments, gasoline bills and car payments, student loans)
- $500 / $2,000 = 25%
- Your debt-income ratio is 25%

Rule of thumb

If your non-housing debt is 10% or less, you’re in great financial fitness. If your non-housing debt is between 10%-20%, then you’ll probably be able to get credit, but as you approach 20%, you’re getting too high!

There have been many attempts to devise formulas for setting limits on the amount of real estate debt one should carry. One rule of thumb is 2 (or 2½ to 3) times your annual income. If the annual household income is $70,000, a mortgage company might loan up to $210,000, provided the house is worth the money and the other credit factors are satisfactory. However, be careful. Just because a lender may be willing to extend credit doesn’t mean that you should necessarily borrow that amount. You should also factor in your own specific fixed and variable expenses to determine your own ability to pay. How much you spend on real estate may depend on what area of the country you live in. Remember, if you’re high on the real estate debt, you may want to be lower on the debt/income ratio to compensate.

Card options

Credit cards vs. debit cards

Deciding when to use your debit card and when to use your credit card isn’t a frivolous decision. A credit card is a “buy-now, pay-later” tool. A debit card is a “buy-now, pay-now” tool. Both cards can play major roles in your money management plan.

A debit card is linked to your checking and/or savings accounts – in banking terms, deposit accounts. When you use a debit card, money is subtracted from your deposit account, generally a checking account. In contrast, a credit card is an unsecured loan that a financial institution provides to you as a payment convenience. Using a credit card means that you intend to repay the amount – plus interest if you do not repay the balance in full each month.

Advantages and disadvantages

Credit has both advantages and disadvantages. By using it wisely, you can capitalize on the advantages and reduce the disadvantages.

Advantages
- Ability to buy needed items now
- Don’t have to carry cash
- Creates a record of purchases
- More convenient than writing checks
- Consolidates bills into one payment

Disadvantages
- Higher cost of items (interest and finance charges)
- May include additional fees also
- Financial difficulties may arise if you lose track of how much you spend each month
- Provides an avenue for increased impulse buying

Three basic types of credit

Single-payment credit

Items and services are paid for in a single payment, within a given time period after the purchase. Interest is usually not charged. Examples include utility companies, medical services and some retail businesses.

Installment credit

Merchandise and services are paid in two or more regularly scheduled payments of a set amount. Interest is included. Examples include some retail businesses, such as car and appliance dealers, as well as commercial banks, consumer finance companies, savings and loans, and credit unions. Money may also be loaned for a special purpose, with the consumer agreeing to repay the debt in two or more regularly scheduled payments.

Revolving credit

Many items can be bought using this plan as long as the total amount does not go over the credit user’s assigned dollar limit. Repayment is made at regular time intervals for any amount at or above the minimum required amount. Interest is charged on the remaining balance. Examples include retail stores’ credit cards and financial institutions that issue credit cards.

About credit reports

Credit reporting agencies

Credit reporting agencies maintain files on millions of borrowers. Lenders making credit decisions buy credit reports on their prospects, applicants and customers from the credit reporting agencies.

Your report details your credit history as it has been reported to the credit-reporting agency by lenders who have extended credit to you. Your credit report lists what types of credit you use, the length of time your accounts have been open, and whether you’ve paid your bills on time. It tells how many loans you’ve taken out and whether you’ve been seeking new sources of credit. It gives lenders a broader view of your credit history than do other data sources, such as a bank’s own customer data.

Credit score

The importance of any factor depends on the overall information in your credit report. For some people, a given factor may be more important than for someone else with a different credit history. In addition, as the information in your credit report changes, so does the importance of any factor in determining your score. Therefore, it’s impossible to measure the exact impact of a single factor without looking at your entire report – even the levels of importance shown in the diagram below are for the general population, and will be different for different credit profiles.

• Your FICO® score only looks at information in your credit report. Lenders often look at other information when making a credit decision, however, including your income, how long you have worked at your present job and what type of credit you are requesting.

• Your score considers both positive and negative information in your credit report. Late payments will lower your score, but establishing or re-establishing a good track record of making payments on time will tend to raise your score.

A few items to consider:

- 35% of your score is based on payment history
- 30% of your score is based on amount owed
- 15% of your score is based on length of credit
- 10% of your score is based on type of credit
- 10% of your score is based on credit inquiries

Creating your credit report

Your credit report does not really exist until you or a lender asks for it. It is then compiled by the credit reporting agency based on the information stored in that agency’s file. This information is supplied by lenders, by you and by court records.

Tens of thousands of credit grantors – retailers, credit card issuers, banks, finance companies, credit unions, etc. – send updates to each of the credit reporting agencies, usually once a month. These updates include information about how their customers use and pay their accounts.

Your credit report reveals many aspects of your borrowing activities. All pieces of information should be considered in relationship to other pieces of information.