MONITOR YOUR FINANCIAL HEALTH

Applying for a loan is a common first step toward buying a home, buying a car or going back to school. The application process itself can be stressful, and there’s nothing worse than hearing your loan application was denied. Even with a steady income and a good payment history, your loan application could be rejected because you already have too much debt. This Action Plan will help you check and monitor your financial health so you can avoid surprises when you need a loan.

Lenders use a variety of financial ratios to predict your ability to pay back your loan. Monitoring these financial ratios will not only help you gauge the likelihood of qualifying for a loan, but you’ll also be able to spot the warning signs of debt before you get in over your head.

This Action Plan will help you calculate five important ratios. Worksheets are provided to help you with each one. If you’ve completed the Calculate Your Net Worth and Start a Spending Plan action plans, you have already done much of the work. If you haven’t, you may want to download the Net Worth and Spending Plan worksheets to help you add up your assets, outstanding balances, expenses and income.

**Assets to debt ratio:** Measures your financial solvency. Assets are things you own that are worth money—cash, stocks, bonds or a house. Your debt is what you owe others—car loan, home mortgage, credit card balance or personal loan. The assets to debt ratio is calculated by dividing your assets by your debt. For example, if your total assets equal $40,000 and your total debt equals $80,000, your asset to debt ratio would be 0.50 or 50 percent. This ratio means that you owe twice as much as you own. With a 50 percent assets to debt ratio, you’d technically be considered financially insolvent, even if you make enough money to cover your current debt on time.

A ratio greater than 1 (100 percent) means you own more than you owe. Keeping your ratio above 1 will put you in a better place to qualify for a loan. For more guidance on managing your debts, see the Manage Your Debt Toolkit.
Basic liquidity ratio: Measures how long you can make it without an income. In other words, how long will your money last before you have to start selling things? The basic liquidity ratio is your total savings divided by your monthly expenses, for a total of how many months you can survive on your savings. For example, if you have $6,000 stashed away in a savings account and your monthly expenses are $2,000 per month, your basic liquidity ratio would be three months.

Your emergency fund should always have enough money to cover at least three months of living expenses. If it doesn’t, you are more likely to be rejected by a lender—not to mention the other problems you may face if you lose your monthly income. For help creating an emergency fund, see the Start an Emergency Fund Action Plan.

Debt service to gross income ratio: Shows you if your monthly debt, including your mortgage, is too high. This ratio looks at all of your monthly debt payments—including your mortgage—compared to your monthly pay before taxes and other deductions are withheld. To calculate this ratio, add up your monthly debt payments and divide the total by your monthly gross pay. For example, if your monthly gross pay is $2,800 and your total debt payments are $1,000 per month, your ratio would be 0.36—or 36 percent of your gross income is needed to pay your debts each month.

If your mortgage payment exceeds 30 percent of your income, you may have difficulty getting other types of loans. For more guidance on managing your debt, see the Manage Your Debt Toolkit.

Debt payments to take-home pay ratio: Shows you if your monthly debt not including your mortgage is too high. This ratio looks at your after-tax income—or take-home pay—compared to your non-mortgage monthly debt payments. To figure this out, add up your monthly debt (not including your mortgage payment) and divide that number by your monthly take-home pay. For example, if your monthly take-home pay is $2,000 and you have monthly debt of $400 without your mortgage, the ratio is 0.20 or 20 percent.

To qualify for a loan, you’ll want to keep your debt payments to take-home pay ratio well below 20 percent. The closer you get to that level the harder, and more expensive, it will be to get credit. For more guidance on managing your debts, see the Manage Your Debt Toolkit.
**Savings ratio:** Tells you whether you are saving enough money. The best way to build up your assets is to spend less than you earn and save the extra money. But how do you know if you’re saving enough? Divide your monthly gross income by the amount you’re saving each month. For example, say your monthly gross pay is $2,000 and you’re saving $200 a month. Your savings ratio is 0.10 or 10 percent.

Financial experts recommend that you save 15 percent to 20 percent of your gross income, which would include pre-tax contributions to retirement accounts, such as the Thrift Savings Plan or a 401(k). For help with managing spending, see the [Create a Spending Plan Action Plan](#).

Now that you have learned how to calculate ratios that will help you monitor your financial health, you’ll have a better understanding of where you stand and have less to worry about when applying for a loan. You’ll want to recalculate these ratios before considering taking on new debt, as your income increases, or as you pay down your credit balances.

Now that you know where you stand financially, see our [Track Your Spending Action Plan](#) to get a sense of exactly where and how you’re spending your money.