Action Plan:
MONITOR YOUR FINANCIAL HEALTH

DIFFICULTY: EASY

WHAT YOU'LL NEED:
- Calculator
- Estimates for total assets and liabilities
- Recent credit, loan and bank statements
- Estimated monthly expenses and income
- Net Worth worksheet
- Spending Plan worksheet

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 Net Worth and Spending Plan worksheets, you have already done much of the work. If you haven't, you can use the Net Worth worksheet and the Spending Plan worksheet to help add up your assets, outstanding balances, expenses and income.

1. **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.

   Use the Asset to Debt Ratio worksheet for help.

   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.

2. **Basic liquidity ratio:** Measures how long you can make it without your income.

   Divide your total savings by your monthly expenses to determine how many months you can survive on just 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.

   Use the Basic Liquidity Ratio worksheet for help.

   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 or face an unexpected major expense.

3 **Debt service to gross income ratio:** Shows 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.

Use the Debt Service to Gross Income Ratio worksheet for help.

If your mortgage payment exceeds 30 percent of your income, you may have difficulty getting other types of loans.

4 **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.

Use the Debt Payments to Take-Home Pay Ratio worksheet for help.

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.

5 **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 the amount you're saving each month by your monthly gross income. 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.

Use the Savings Ratio worksheet for hep.

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.