

# Debt Ratios from Your Money Ratios

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I've previously discussed the book [Your Money Ratios](#) on this blog, which is subtitled 8 Simple Tools for Financial Security at Every Stage of Life. Last time I discussed the [capital to income ratio](#). Mr. Farrell also discusses the savings ratio, in which he says save 12% of your income up to age 45, then 15% thereafter. In this post, I'd like to explore two other ratios that he suggests to help you meet your retirement goals, his mortgage to income ratio and his student loan to income ratio.

When you go to take out a mortgage, a bank considers your ability to make the payments each month. They look at your income, and at your outstanding debt, as well as your record of paying off your debts. Guess what they don't look at? Your savings rate and your retirement plans. Newsflash! The bank doesn't care if you ever have a comfortable retirement. They will loan you a lot more money than you should borrow. So how much should you borrow? In his revolutionary book, Mr. Farrell provides the answer, at least for someone who wants to pay off his mortgage about the time he retires in his mid-60s. Here's the chart:

Age	Mortgage to Income Ratio
25	2
30	2
35	1.9
40	1.8

45	1.7
50	1.5
55	1.2
60	0.7
65	0

A couple of things stand out when you look at this chart. First, the fact that you should never borrow more than twice your income for a mortgage. That's been a general rule of personal finance for years, and still holds true. Although often disobeyed, such as in the recent housing bubble, and frequently in cities such as Manhattan and San Francisco, it's the best rule I know and one I follow religiously. In fact, for those who live in expensive places where decent housing is impossible at those ratios, even for doctors, I think it is probably wiser to rent. I couldn't believe it when a friend in the Bay Area told me he was renting a house worth \$1.5 Million for \$2K a month. You should rent your entire life at buy:rent ratios like that. What a lousy investment that landlord had, especially now that the house is worth less than \$1 Million.

The second thing you see from the chart is that you're not making much progress in the first 15 years. Part of that might be because you are upsizing from one house to another as your family and income grows, but part of it is just the nature of a 30 year mortgage. It's almost all interest in the first decade. That's why I'm a big advocate of the 15 year mortgage. Guess what my mortgage to income ratio is going to be at 50? It won't be 1.5. It'll be zero.

The last thing you can see on the chart is that it doesn't matter so much that you buy at 25 or 30. It's okay to rent for a while and not buy a house until 35 or even 45. The ratio is only ~1.8 then.

Let's move on to the student loan to income ratio. I was very

interested in seeing what Mr. Farrell had to say about this important subject, having written on the [rapidly increasing cost of education](#), particularly medical education, recently. I was a little disappointed to see him insert this caveat as he gives his ratio:

Even though very high wage earners, like doctors, could arguably support a little higher debt because they will likely have more discretionary income, I suggest no one go higher than 75% of average earnings unless they have enough income to pay for tuition without debt, or are a lock for big scholarships or financial aid.

That's it. That's his ratio. 75% of expected average earnings. So if you're going into primary care, and you see the average salary in your field is \$160,000, you shouldn't run up more than \$120,000 between college and med school (including accrued interest in residency.) Now if you're looking at a mid-paying specialty, such as EM with an average salary in the mid to high \$200s, you could justify up to perhaps \$200K in debt, and an orthopedist expecting \$400,000 could perhaps justify up to \$300K in debt, which is rapidly becoming the standard for many medical schools.

His ratio also means that more typical Americans, making say \$50,000, shouldn't run up more than \$37,500 in college. He's right when he points out that education is a particularly inefficient market. There are some serious deals there. For instance, I left college with just \$5K in debt, and no, my parents didn't pay any of it. Well, almost none of it. Through scholarships, summer work, part-time work, and choosing a low cost school I escaped with nearly nothing in debt. At the same time, someone borrowing the entire cost of attendance at a private liberal arts college could easily have \$200,000 in debt after just four years. Scholarships, military and employer assistance, and the vast difference

between the cost of similar educations make for a very inefficient market.

Medical school is quite a bit more efficient than the college market, but tuition still ranges from \$10,000 to \$70,000 a year. Even so, I'd be very cautious exceeding his 75% number for a few reasons. First, doctors aren't that different. Sure, they have higher earnings per year, but that is quickly eroded by additional taxes, bigger lifestyles, and a shorter earnings career. Second, declining reimbursements are real. I don't know any doctors who expect to be making what they're making now in 5 years. If you take out 75%+ of what you expect to make, then your salary is cut in half, you're going to be a slave to your student loans. Last, you know as well as I do that most medical students change their mind about specialty after entering medical school, when the money has essentially already been spent. If you take out loans equal to 75% of what an orthopedist makes, then end up as a pediatrician, you're hosed. You're stuck with the unsavory choice of practicing a specialty you don't want to do (or cannot match into), or never achieving financial independence due to an outsized debt burden.

Pre-med students shouldn't kid themselves. Big loans WILL severely impact you down the road, even on six figure salaries. Look at Farrell's chart about how much of your income will be eaten up by loans at today's interest rates:

Debt as Percentage of Avg. Pay over 10 Years	Repayment as Percentage of Annual Pay at 7% Interest over 10 Years
25%	3.50%
50%	7%
75%	10%

100%	14%
125%	17%
150%	21%

Do you really want to be spending more than 10% of your GROSS income on student loans? Keep in mind that after you pay your taxes (25%), retirement (15%), and mortgage (15%) you're really talking about 25% of your pay going toward student loans even at the recommended 75% ratio.

Lastly, Mr. Farrell talks briefly about car loans and consumer loans. No surprise that he says no consumer debt. That's solid financial advice that has stood the test of time. However, unlike Mr. Farrell, I lump automobiles in with consumer debt. He says take out as a little as possible for a car. I say as little as possible is zero. There's no reason a doctor needs to borrow money for a car. \$2000 gets you a car that will take you to work. You can save that out of your next check. You need to be saving more than that toward retirement each month anyway. If you want something nicer, save it up and pay cash.