Debt Rate

ASSESSMENT GUIDE

Debt Rate (Dr) is the percentage of a client's annual gross income being allocated toward required debt payments.

Elements®
Financial Planning System

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Debt Rate

Assessment Guide

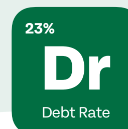
What is it?

Debt Rate (Dr) is the percentage of a client's annual gross income being allocated toward required debt payments.

CALCULATION

Total Annual Debt Payments
÷ Total Personal Income

Debt Rate



Debts include payments toward:

- Personal real estate (primary mortgage, HELOC, etc.)
- Business debt (acquisition, equipment, etc.)
- Commercial real estate (condo, rentals, etc.)
- Student loans
- Other (auto loan, personal loan, other depreciating asset loans, etc.)

Example: If you're spending $3,000/month on mortgage

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payments and $500/mo on student loan payments, and your household is earning $200,000 in annual income, your Dr is 21%

Why is it important?

Overall debt levels have risen substantially over the past 30 years. Most notably, younger generations are in a fairly unprecedented economic period. Student loan and total debt-to-income ratios are very high, especially for those with more than a bachelor's degree or those who attend private schools. It's not uncommon to see a graduate with student loans over four times their expected annual income.

While managing debt levels has always been a component of overall financial health, it is likely to be a more frequent part of 'the conversation' today.

Tracking Debt Rate allows you to continuously monitor how much of your clients' income is going toward debt payments. It helps you assess how their debt rate changes over time to identify patterns, to make smarter decisions about financing, and to help clients avoid getting into hot water where they lose optionality and risk emotional stability.

How do I use it?

Use the process to assess whether a client's Debt Rate is appropriate or if they need to make improvements:

1. **Accuracy:** ensure the accuracy of the Debt Rate inputs.
2. **Assessment:** assess whether the given Debt Rate is appropriate.
3. **Improvement:** Identify areas of improvement

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STEP 1

Score Accuracy

1. Extra Debt Payments: In Elements, extra debt payments (anything entered as “extra debt payments” above normal recurring payments) are included as part of Savings Rate, not Debt Rate. This is primarily to not “punish” a client for making extra debt payments with a higher debt rate with money that would likely otherwise go towards savings.

BEST PRACTICE

Any extra debt payments beyond the required minimum payment should be entered as an “extra debt payment” therefore excluding them Debt Rate (including them in Savings Rate), so long as they are recurring (i.e. client makes an extra debt payment each month or each year), not “one-time” (e.g. client gets a bonus and pays down some debt).

> **Example:** A client has a mortgage with an outstanding balance of $75,000 and a required monthly payment of $1,200. The client also contributions $300 per month as extra debt payments to reduce principal. $1,200 will be included in the Dr element, and the $300 will be included as an extra debt payment under Savings.

2. Mortgage Escrow: Clients often include mortgage escrow payments with the estimated payment value they provide you.

If the escrow is a relatively small amount of the payment, you can simply include it in Debt Rate knowing that the score will be minimally impacted.

If the escrow is a substantial portion of the monthly payment, we recommend excluding it from the debt payment and including it in general spending instead.

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3. Credit Card Debt: In Elements, credit cards only have “extra payments” instead of monthly payments and extra payments (like with other debts).

BEST PRACTICE

If a client pays off their balance each month or doesn’t carry a balance for longer than a year, do not enter any payments.

If they do carry a balance on credit and will pay it off over multiple years, include it .

> **Example:** A client has a line of credit with a balance of $20,000. They plan on paying down that balance over the course of 2 years. This should be included in “recurring extra payments”.

STEP 2

Score Assessment

To assess this score:

1. **Determine whether the score is too high, too low, or just right.**
2. **Identify roadblocks to improvement**

Score Ranges

Average Debt Rate scores depend on a variety of factors, the most prominent being the client’s chosen career path and their aversion to debt. The following graph presents the range of average Debt Rates.

Low	Average	High
10–15%	**20–30%**	**+40%**

Correlating Factors

Understanding the correlation between these factors and your clients' savings habits will help you determine if the given Debt Rate is appropriate or not.

Savings Rate: High Savings Rate = Low Debt Rate

Debt Tolerance: Low debt tolerance = High Debt Rate

Age: Older = Low Debt Rate

Career: Different careers necessitate different debt levels. For example, someone with an advanced degree is more likely have much higher levels of debt than someone without one.

STEP 3

Score Improvement

In the majority of cases, you will work to decrease a client's debt rate. This is most likely to be the case where the client needs to start saving, but there's not yet enough free cash flow to do so.

However, some clients' financial situations might allow you to focus on increasing their debt rate. This could occur to fund an investment opportunity or business expansion (not to fund a lifestyle beyond what the client can afford).

As you identify which direction the client should move to improve their debt rate, you may want to consider the following questions:

- **What is the purpose of the debt?What are the interest rates / terms on their existing debt?**
- **What is the client's debt tolerance?**
- **Does the client have ample liquidity?**
- **If the Debt Rate is too high, in what order should the**

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client pay down debts?

- If the Debt Rate is low, could the client utilize more debt to accelerate growth?
- Should the client consolidate or refinance some debt?

As you review these questions, you'll be able to guide the client toward good financial behaviors that ultimately improve their financial health.

Case Study

Let's look at the following example and apply the principles presented above. This case study assumes you've already ensured that you have a good estimate.

Example: Given a Debt Rate of 35% and considering the following information, you begin your assessment of whether a client's Debt Rate is appropriate:

Debt Rate	**35%**
Savings Rate	**15%**
Debt Tolerance	**Low**
Age	**36**
Career	**State Employee**
Lifestyle	**Average**

Step 1 – Determine Score Appropriateness: The single most important factor here to consider is the client's savings rate at 15%. From the

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previous assessment of their savings rate, you've determined a need to increase their Sr score beyond 15% and therefore a need to create more free cash flow to do so.

While their age is low and they have a low tolerance for debt, all other factors indicate this debt rate is too high. Therefore, you decide to focus on decreasing their debt rate.

Step 2 – Identify Improvements and Roadblocks: Through fact-finding with the client you discover they have a high mortgage balance with a 15 year term. With low current interest rates and the opportunity to decrease monthly payments by extending the term, you recommend the client refinances to a 30 year mortgage. This will decrease their debt rate significantly and allow them to allocate a higher percentage of income toward savings.

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