Credit-Card Debt: How Much Is Too Much?

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Posted: February 12, 2020 Personal finance, Personal loans

15 min read

How much credit-card debt is too much? It depends on how your credit-card debt is affecting your life:

- Too much to let you sleep at night?
- Too much to get car loans, student loans or mortgages?
- Too much to have a good credit score?
- Too much for good financial health (net worth)?

The fact that you're reading this article probably indicates that you're concerned. So the first question is, How worried should you be?

Need a personal loan to reduce credit-card debt? Check interest rates here.

5 Signs of Possible Credit-Card Overuse

A wallet full of credit cards and high(ish) balances does not necessarily mean trouble, or that you're mismanaging your credit-card debt. But these signs may be cause for worry:

1. You only make minimum credit-card payments

Credit-card issuers love people like you. Consumers who always make their credit-card payments, but only pay the minimum, are the most profitable.

When you make minimum monthly payments, the money mainly covers interest charges. Your credit-card balances barely budge. And if the reason you're only paying the minimum is that you can't afford to pay more, that's a big red flag.

2. Your credit-card balances keep increasing

Credit cards offer real advantages. But ideally, you should use credit cards for convenience or rewards and pay them off every month.

Yes, you may need to extend repayment by a month or two if you experience a personal finance hiccup - an unusual expense or income glitch that creates a temporary cash-flow problem. But steadily increasing credit-card balances highlights the fact that you're spending more than you bring in. This is unsustainable and can lead to bankruptcy.

3. You use one account to pay another

One sign of healthy finances is paying off your debts with your monthly income - not with more debt. And you can't save money as long as your monthly income is supporting credit-card-interest payments.

4. Your credit cards are maxed out

Being "maxed out" means using your credit cards until your balance is close to - or even over - your credit limit. Going over can trigger a higher default rate, which means your card issuer can raise your interest rate for failing to comply with the terms of your agreement. Being maxed out, or close to it, also affects your credit-utilization ratio and your credit score (more about that below).

5. Credit-card payments leave room for little else

Some kinds of debt are necessary. In many parts of the country, you need a car to get to work or school. Auto loans can help you buy a vehicle when you can't pay cash. Eventually, your car payment zeros out the loan balance and you own your asset free and clear. Mortgages and student loans work the same way. You use them to purchase a home or education, pay them off over time, and eventually you have no mortgage, car loan or student loan debt.

High credit-card debt, on the other hand, leaves little room for good loans that help you acquire assets. And their revolving nature, which allows you to run up balances after paying them down, can keep you in debt forever.

How Do Lenders Look at Credit-Card Debt?

When you borrow for a home, auto, college education, boat or anything else, lenders don't care so much about your credit-card debt. Carrying credit-card debt may not be the wisest financial decision; but if you can afford the minimum monthly credit-card payments, plus your other accounts, *plus* the new loan, lenders don't care that much.

What mortgage and auto lenders care about most is the total amount of debt. They examine your *total* monthly debt payments and how that relates to your gross monthly income. They call this relationship your debt-to-income ratio, or DTI.

What is debt-to-income ratio?

Here's how to calculate debt-to-income ratio:

1. **Total your monthly debt payments**

   Add up your rent or mortgage (including property taxes and homeowners insurance), monthly payments for accounts like auto loans, student loans and personal loans, and the minimum payments for your credit-card balances.

   (**Note:** Don't include living expenses like food, utilities and transportation in this total.)

2. **Total your monthly gross income (before taxes)**

   This includes wages, self-employment income (adjusted for deductions and depreciation), investment income, pension income, alimony/child support or government payments that are stable and can be expected to continue into the future.

3. **Divide your total debt payments by your total gross income**

Here's an example of how a loan underwriter might calculate the DTI. You'll note that the underwriter uses the new total debt (including the loan for which the borrower is applying) when calculating DTI.

Rent	$1,000
Credit Cards	$275
Student Loan	$100
Total Payments	**$1,375**
New Car Loan	$400
New Total Payments	**$1,775**
Wages	$4,500
Business	$2,500
Total Gross Income	**$7,000**
DTI	
$1,775 / $7,000	**25.36%**

When is your DTI too high?

There are many rules of thumb for what makes a good DTI. Here is a list of the most common:

- 36% is the maximum DTI to obtain the best terms for some common mortgage programs
- 36% is also the maximum DTI many personal-loan providers accept for top-grade interest rates
- 41% is the official maximum for VA mortgage borrowers (however, there are other, more liberal VA guidelines)
- 43% is the maximum DTI for many mortgages that are sold to investors
- 43% is also the maximum DTI accepted for many personal-loan programs
- 50% is the limit for a small set of personal-loan programs and some government-backed mortgages (additional conditions may apply)

Loans accepting borrowers with DTIs exceeding 50% exist. However, these loans can be very damaging to most borrowers and should be avoided in most cases.

DTI and your lifestyle

One thing to keep in mind is that DTI does not reflect all of your costs - most of the time, it just includes your housing expense and the accounts that appear on your credit report. But DTI does not include your taxes, money that you set aside in savings, charitable contributions, insurance, expensive hobbies and living expenses.

Point being that you can have a healthy DTI on paper and still find yourself in trouble financially. And what about that credit-card debt? Some accounts have very low minimum-payment requirements. So you can have very high debts while still maintaining a respectable DTI.

Too Much Debt Kills Your Credit Score

The relationship between the amount of credit-card debt you carry and your credit score is pretty straightforward. The most important component of your FICO credit score (FICO is the most common scoring system) is your payment history. That comprises 35% of your score.

But the second most important factor is credit-utilization, and that's 30%. How much you owe is almost as important as whether you pay it back on time.

What is credit-utilization ratio?

Your credit-utilization ratio applies only to revolving debt. That means accounts that you can pay down and reuse, like lines of credit and credit cards. Calculating credit utilization is simple:

1. **Total the limits of all revolving accounts**

   HELOCs, or Home Equity Lines of Credit, don't count even though they are revolving accounts. That's because they are also mortgages.

2. **Total the current balances of all revolving (non-HELOC) accounts**
3. **Divide the total balances by the total available credit**

For example, if you have three credit cards with a total limit of $10,000, and you owe $5,800, your utilization ration is 58%.

What is a good utilization ratio?

Many personal finance experts advise consumers to keep their credit-utilization ratio under 30%. However, consumers with the very highest credit scores keep theirs even lower - closer to 10%, in fact.

And there are other considerations.

According to credit-reporting agency Experian, your total-utilization ratio and also "per-card" ratios matter too. So it's better, if you have two cards with $5,000 limits each, to charge $2,500 per card instead of $5,000 on one and none on the other. Either way, you have a 50% total-utilization ratio (which isn't great). But if you charge everything on one card, you also have a 100% ratio on the "per-card" calculation.

Unbalanced right now? Consider balance transfers to move some debt from one card to another.

Credit utilization and your credit report

Finally, the timing of your credit use and repayment matter. Suppose that you have a $10,000 rewards card that you use for everything - groceries, gas, utility payments, you name it. And you charge about $2,000 a month and pay the bill in full each month. You might think that your utilization ratio is zero as long as you never carry a balance.

You would be wrong.

Your utilization ratio (and credit score) depend on when your credit-card issuer reports your balance to the credit-reporting agencies. That may be at the end of a 30-day billing cycle - but not necessarily. There is no law requiring creditors to report your balance monthly - or even at all.

If you plan to apply for a loan and want your credit score as high as possible, stop using your credit cards. Pay off your balance or at least get it as low as possible. If you must use your card, make an immediate online payment from your bank to clear the balance.

Can you improve your credit score by ADDING credit?

There are five tried-and-true ways to improve your credit utilization. But one of the five might not improve your credit score.

- Pay your credit card balances down as quickly as possible (while paying attention to "per-card" limits as well)
- Keep credit cards with zero balances open even if you never use them
- Apply for a credit increase with a current issuer
- Apply for a new credit card
- Consolidate credit cards with a personal loan

Applying for a new credit card causes a hard inquiry on your credit report. It signifies that you're looking for credit and that can drop your FICO score by about five points per application.

And once you open your new account, the average age of your accounts (which comprises 15% of your credit score) falls.

Finally, having "too many accounts" is commonly listed as a reason code for lower credit scores. So add judiciously.

Consolidating credit cards with a personal loan can raise your FICO quickly. That's because by moving your debt from a revolving account to an installment account, it no longer figures in your utilization ratio. The one downside is that many credit cards have low minimum monthly payments. Your personal loan payment, even if the interest rate is lower, could be higher. Make sure you can afford that.

Compare Personal Loan Rates and Apply Online:

Bank/Institution	APR	Loan Term	Max Loan	
LendingClub	6.95 - 35.89%	36 - 60 months	$40,000	Type: Personal Loan SEE MY RATE Advertiser Comments
Payoff	5.99 - 24.99%	0 - 60 months	$35,000	Type: Personal Loan SEE MY RATE Advertiser Comments
freedomplus	5.99 - 29.90%	24 - 60 months	$40,000	Type: Personal Loan SEE MY RATE Advertiser Comments

Too Much Credit-Card Debt? Kiss Your Net Worth Goodbye

Most of us don't plan to spend our lives in debt. While we may have to borrow to purchase assets like cars or homes, the goal is asset ownership and positive net worth.

What is net worth?

Net worth is your total assets minus your total debts. Ideally, it's a positive number.

In this example, Consumer A owns a 220,000 home with a $200,000 mortgage against it. She has a $15,000 car with no loan, $75,000 in retirement savings, $5,000 in a checking account and $4,000 of credit-card debt. Here's what her net worth looks like:

Home Value	$220,000
Car Value	$15,000
Retirement	$75,000
Checking	$5,000
Total Assets	**$315,000**
Mortgage	$200,000
Credit Cards	$4,000
Total Debts	**$204,000**
Net Worth	
(Assets - Debts)	**$111,000**

Using credit cards too much and paying them down too little sabotages many Americans' personal net worth.

How credit cards can harm net worth, even if you don't spend more

To illustrate this, let's look at two neighbors who rent, take public transportation, own nothing and owe nothing. Both earn $5,000 per month, and both have $2,000 per month after paying all necessary expenses. They both decide to take their families on an amazing vacation costing $22,500.

Neighbor A invests $2,000 a month in mutual funds and earns an average return of 7%. After one year, his family has $24,785. They take their $22,500 trip and, at the end of a year, their net worth is $2,285.

Neighbor B puts $22,500 on credit cards to cover the trip and leaves right away. He's not the best money manager and pays a 21% interest rate on his credit card. His monthly payment is $2,095. But remember that he only has discretionary income of $2,000 per month. At the end of a year, then, he still owes $1,257. His family has *negative* net worth.

Imagine that this goes on year after year. Both families take a vacation every year and spend the same amount for it. But over the years, Family A's net worth increasingly becomes more positive - while Family B descends deeper in debt.

How to Get Out of Credit-Card Debt

If the plight of Family B doesn't scare you, it should. Millions of Americans share it. But if your debts have crept up on you because of poor spending decisions or bad luck, you can turn things around. Here are several solutions, from the least drastic to the most drastic.

Before attempting any of these solutions, create a workable budget and a system for staying on it. Get professional help if you don't know how to create a budget or if you can't control your spending. Without discipline and a workable plan, many debt experts believe that your chance of success is only 15% to 25%.

The "waterfall"

The waterfall is a DIY plan to pay off your credit cards on your own. It works like this:

Make the minimum payment on all cards except the one with the highest interest rate. Suppose you have three cards:

- Card A has a 15.55% rate and a $200 minimum payment
- Card B has a 22.99% rate and a $50 minimum payment
- Card C has a 27.99% rate and a $100 minimum payment

You can afford to pay an extra $100 a month toward your credit-card balances. Continue to make the minimum payments for Card A and B. But because Card C charges the most interest, start paying the extra $100 toward that balance. (Your total for all three cards will be $450 per month.)

It's important to note that, as your balance drops, your minimum payment might also - but keep sending in the bigger amount.

Once Card C has been paid off, you'll be able to send $200 per month *plus* the regular $50 payment to get rid of Card B. (Your total payment for two cards will still be $450 per month.) And finally, you'll take aim at Card A and send in $450 a month until you owe nothing.

The "snowball"

The snowball works exactly the same way as the waterfall method, except that you start with the smallest balance and work your way to the largest. It is less effective for saving interest because your smallest balance might not be the one with the highest interest rate. But many like it because you achieve a loan payoff faster - and that can be truly motivating.

These are good options if you can afford your minimum payments plus a little extra, you don't qualify to refinance your debt at a lower rate, and you're not in serious trouble.

Consolidate debt with balance transfer cards

If you have a decent credit rating, why not leverage it and move your expensive credit-card balances to zero-interest accounts? You typically get between six and 21 months at zero interest.

Because the entire payment goes toward reducing your principal, you can accelerate repayment.

Understand that balance transfer cards typically charge a fee (about 3%) to move your balance over to a new account. And remember that, once the zero-interest period expires, you'll be paying interest on the remaining balance.

This move is best for manageable amounts that can be cleared in less than two years. Borrowers must have good to excellent credit.

Consolidate debt with a personal loan

Personal loans offer some advantages that may help you clear your credit-card balances faster. First, they normally come with lower interest rates than comparable credit cards. Those interest rates are usually fixed, which makes budgeting easier.

Another important advantage is that personal loans are installment loans. You can't run the balances back up; you can only pay them down. And by consolidating several credit cards with a single personal loan, you reduce the amount of bookkeeping you do each month.

A bonus advantage is that your credit score may increase once you've replaced your revolving credit cards with a single installment loan.

There are some cautions:

- Your payment could increase even if your interest rate is lower.

  Personal loans are not designed to be carried for decades like credit cards with tiny minimum payments. That's good in the long run; just don't shoot yourself in the foot by committing to a payment you can't afford.

- Any form of debt consolidation will fail if you can't stop overspending. This includes personal loans.
- Not all personal loans are created equal. Avoid cash-advance loans, check-advance loans, payday loans, and title loans. All of these may be advertised as "personal loans" but will only get you into deeper trouble.

Personal loans work well for consumers who need more time to pay off their credit-card debt, while home equity loans can offer the lowest interest.

Credit counseling and debt-management plans

If you need professional help, look for a reputable, non-profit credit counselor. Credit-counseling services may offer help with budgeting, assistance to control overspending, intervention with credit-card companies (even getting your interest rates or payments reduced in some cases) and debt-management plans, or DMPs.

A DMP is a plan set up by the counselor and agreed to by your credit-card issuers. You make a monthly payment into the plan and your counselor distributes it among your creditors. As with debt-consolidation options, there are pitfalls:

- There are fees - understand clearly how much of each payment goes to your creditors and how much goes to the counselor.
- Make sure you can afford the payment, and that it will clear your debts in a reasonable period of time. (Some experts recommend considering bankruptcy if you can't clear your debts on a five-year DMP.)
- Check with your creditors to make sure they are receiving your payments and monitor your credit report periodically.

There are many ways to get yourself out of too much credit-card debt. Of course, the best way is to avoid borrowing too much in the first place.