Understanding Your Debt Service Ratios

BRIDGEWATER BANK

Understanding your debt servicing ratios

Whether you're taking on another mortgage or refinancing, how do you know if you can afford to make the new mortgage payment? There's a ratio for that — it weighs your financial obligations against your income. No lender wants to see you get into too much debt, so they look at your debt servicing ratios to see just how much you can afford to borrow.

How are debt servicing ratios calculated?

There are two ratios you need to worry about — gross debt servicing (GDS) and total debt servicing (TDS)

- **Gross debt servicing (GDS)** is the maximum amount you can afford for shelter costs each month. It's your monthly housing costs divided by your monthly income.
- **Total debt servicing (TDS)** is the maximum amount you can afford for debt payments each month. It's your monthly debt and housing costs divided by your monthly income.

If too much of your income is already going to housing costs and debt payments, according to your lender, you may not be able to afford to take on more debt.

Your debt servicing ratios are important

Lenders use ratios to assess risk and understand if you will be able to make your payments on a mortgage. Generally, lenders like to see a GDS ratio around 32% and a TDS ratio that is no greater than 40%. If the ratios are higher, that does not mean you won't qualify for a mortgage, but you may end up paying a higher interest rate.

In general, the better your debt servicing ratios and credit score, the lower your interest rate will be. This is because lenders view you as more reliable and it shows that you manage your money well and make your payments on time. Even if you need to refinance now, at a slightly higher rate, you can look at getting into a lower rate in a couple of years, when you mortgage term is up for renewal.

Your debt servicing ratio also lets you know how well you're managing your budget. If your TDS ratio is over 44%, you are spending too much of your income on debt already and you may be unable to borrow without a co-signer. A co-signer's credit history and income is factored in with yours. This gives the lender some reassurance that the payments will be made because the co-signer is as responsible for the mortgage as you are.

Calculating your personal debt servicing ratios

Start by adding up your monthly debt payments. Include those fixed costs that you must pay every month:

HOUSING COSTS	DEBT COSTS
Rent or mortgage payments	Loan payments, such as car, student, or personal loans
Property taxes	Credit cards (3% of the outstanding balance)
Heat	Outstanding bill payments not on a credit card (dental, medical, repairs)
50% of condo fees	Interest charges for line of credit payments
	Spousal or child support payments

Next add up your monthly income:

- Pay cheque (before taxes)
- Retirement or pension payments
- Benefits payments
- Spousal or child support
- Rental income
- Any other monthly income

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Formulas:

Gross debt servicing ratio

$$\frac{\text{Housing Costs}}{\text{Total income}} \times 100$$

Total debt servicing ratio

$$\frac{\text{Housing Costs + Debt Costs}}{\text{Total income}} \times 100$$

Examples:

Your income (before taxes) is $6,500 per month. You have a monthly mortgage payment of $1,400, property taxes of $ $300, and $ $100 for heat. Your GDS ratio is calculated as $1,800/$6,500 x 100 = 27.69%

Your income (before taxes) is $6,500 per month. You spend $300 for your car payment. You have $2,500 in credit card debt, and 3% of the outstanding balance is $75 for a total of $375 per month. Your TDS ratio is calculated as $2,175÷ $6,500 x 100 = 33.46%.

To learn more about specific mortgage approval ratios, check out this handy article.

Note: If you have a two-income household, include the debt payments and income for both of you. This is important because you have more income between you, and you share the cost for some of the debt.

Tips for lowering your debt servicing ratios

There are two basic ways to improve your debt servicing ratios — increase your income or reduce your debt.

Increasing your income is not always possible, although it could include a raise at work, finding a new job with better pay, or taking a second job. If you do find yourself with a little extra cash — maybe you received a year-end bonus — consider using it to pay down your debt.

Paying down your debt and not adding to it is the best way to improve your debt servicing ratio. Here are a few ideas to get you started:

- Avoid making new purchases, especially if you need to use your credit card to make the purchase.
- Create a budget and see where you can cut expenses. Apply those savings to your debt.
- Call your credit card company and try renegotiating a lower interest rate. With a lower rate, more of your payment will be applied to what you owe
- If you have money sitting in an account that is not earning much interest, consider applying it toward your debt, which tends to have a higher interest rate.
- Explore options to refinance equity from your home to pay off debt (work with your mortgage broker to form a plan).

Debt servicing ratios and your credit score

Your debt servicing ratios do not directly affect your credit score but carrying a large amount of debt can negatively affect both. And lenders will look at both when assessing your mortgage application. The good news is that reducing your debt improves your credit score as well as your debt servicing ratios. Work with your mortgage broker to create a plan on how you will reduce your debt and improve your ratios.

Your debt servicing ratios give lenders information about your ability to repay the money you borrowed while your credit score provides information about the way you manage credit. Do you make payments on time? Do you have a history of borrowing and repaying money?

Now that you know how a lender is going to assess your mortgage application, you can take the necessary steps to lower your debt servicing ratios and get that mortgage approved!