

# Debt Service Ratios

*By Brian Madigan*



Before you can buy property, you will need to qualify for a mortgage. There are, of course, exceptions: you could win the money in a lottery, receive it from an inheritance or have it loaned to you by a friend (when I say friend, I really mean parents, nobody has friends like this).

However, if you are like most people, then you will have to qualify for a mortgage. This means having a good credit rating and having a good income.

When it comes to income a financial institution (like a Bank) will have some internal rules or policies that it will apply in most cases.

*Gross Debt Service Ratio:* This is the maximum amount of a borrower's income that may be directed to the mortgage payment (principal and interest) and taxes. Sometimes, it will also include heating costs and some lenders include 50% of the condominium fees.

This GDS is usually in the range of about 27% to 32% of a borrower's gross income, that is the income before taxes. In the case of the self-employed it will be net income (after expenses) but again before taxes.

*Total Debt Service Ratio:* This is the total amount of all outstanding debt obligations together with the GDS. The usual range here is about 37% to 40%. So, if you have existing credit card debt, bank loans, investment loans, and car loans they will have to be considered in the calculation. The theory here is that at least 30% of your gross income went in income taxes. Another 5% goes in other taxes. And, if you pay 40% of your remaining income on the mortgage, the property and your other debts, then this leaves you with just 25% for all the rest. In the Bank's experience, this is getting a little tight. They do appreciate that you have to live.

So, if you want to qualify for a larger mortgage, then reduce your debt ahead of time. A helpful banker might suggest that you consolidate some of your loans, namely the credit cards so that you will qualify for the mortgage. Overall, this might be a good strategy. It reduces the interest you are paying

on your cards. The savings could be substantial. However, it hides the real cost of the debt, and this could be a serious mistake.

If it allows you to qualify, by bringing your TDS ratio into the right line, then that's fine. Otherwise, you couldn't buy the property!

But, if you still qualify and there is a little extra room in your GDS ratio and TDS ratio, then, you should be a little cautious. The trick here is to know what you bought. Let's say you bought a new \$ 5,000.00 plasma TV. It will last for 10 years and after that it will be rubbish. If you simply add it to your mortgage and you have a 25 year amortization you will be paying for it (both principal and interest) for 15 years after you threw it out. This doesn't make any sense at all.

So, be careful when it comes to your finances. Don't pay too much interest. Even if you are paying a lower rate; if you pay for 25 years rather than 10 years, then you are really paying far too much.

When you are shopping for a mortgage, the lenders' GDS and TDS ratios are very important considerations. You might qualify at one institution and not at another. If you are seeking the maximum mortgage that you can afford (which most people are), this could make a real difference.

If you are concerned and would like some assistance, or a referral to a mortgage broker or lender, please give me a call.

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