

Box B

Households' Mortgage Prepayment Buffers

In Australia, households often choose to pay down their mortgage more quickly than required. Various data sources suggest that around half of borrowers are ahead of schedule on their mortgage. In this way, many households have a buffer that they could temporarily draw on to stay current on their loan repayments if their incomes were to fall. The share of Australian households paying their mortgage ahead of schedule is high compared with many other countries, though the available evidence suggests it is broadly similar to Canada.

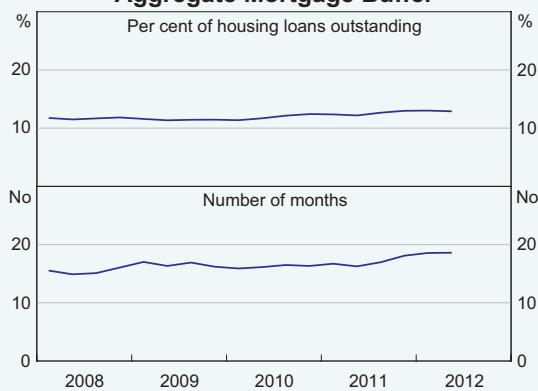
In aggregate, the stock of Australian households' prepayment buffers is estimated to be equivalent to over 10 per cent of the outstanding stock of housing loans (Graph B1). This includes balances in mortgage offset and redraw facilities. Flows into these accounts include regular excess repayments and one-off excess repayments paid out of salary bonuses or other irregular income. The stock of prepayments has risen recently, in part because most borrowers do not change their regular repayment amounts when interest rates fall. Some borrowers have also been choosing to make very large prepayments

recently; according to the latest HILDA Survey, the share of indebted households who made substantial principal repayments on their mortgage (of \$25 000 or more over the year) was significantly higher in 2010 (22 per cent) than the average between 2002 and 2007 (15 per cent).¹

Measured a different way, in aggregate, indebted households' mortgage prepayment buffers are estimated to be equivalent to around 1½ years of scheduled repayments (principal plus interest) based on current interest rates. While this average figure is boosted by a group of borrowers that are significantly ahead of schedule – liaison with the major banks suggests that around 15 per cent of borrowers are ahead by two years or more – many borrowers still have sizeable buffers. Of those borrowers that are ahead on their mortgage: around 45 per cent are estimated to have a buffer of up to six months; 15 per cent have a buffer of between six months and a year; and over 40 per cent have a buffer greater than one year's repayments (Graph B2).

Data from the HILDA Survey suggest that households with large mortgage buffers tend to be older and have higher incomes, which is consistent with these households having had more time and/or income to accumulate such buffers (Graph B3). Borrowers that have small or no buffers tend to be younger or have more recently taken out their loan. Even among these latter groups, however, just over half of borrowers are reported to be ahead of schedule on their repayments. The bulk of households that are not ahead of schedule on their mortgage are not in financial stress;

Graph B1
Aggregate Mortgage Buffer

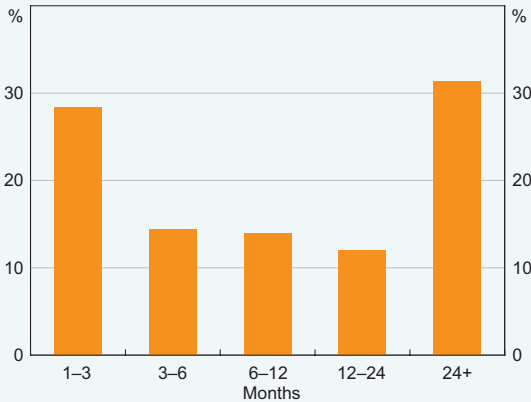


Source: APRA

¹ See RBA (2012), 'Box B: Home Mortgage Debt: Recent Insights from the HILDA Survey', *Financial Stability Review*, March, pp 53–56. Generally, the HILDA Survey interviews the same set of individuals each year, mainly between August and November, with the latest published results being for 2010. It therefore makes it possible to trace individual changes in housing debt over the past decade.

Graph B2
Mortgage Buffers*

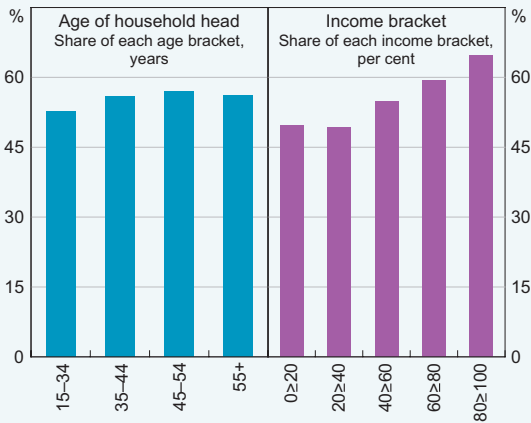
Share of ahead-of-schedule borrowers, 2012



* Estimates from a sample of large banks
Source: RBA

Graph B3
Mortgage Borrowers Ahead of Schedule*

2010



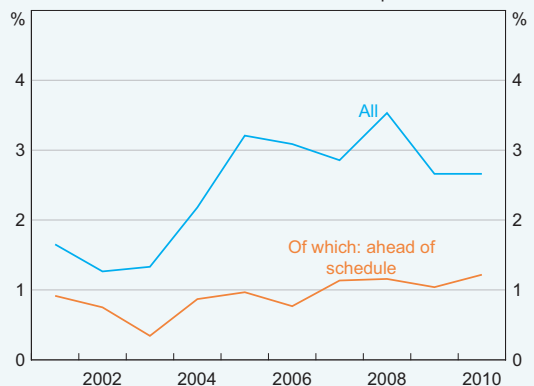
* Owner-occupier households with mortgage debt
Source: HILDA Release 10.0

roughly half of indebted households are paying their mortgages on schedule, with only a very small share of borrowers in arrears. Some borrowers may have chosen to take out loan products that discourage excess repayments but nonetheless suit the borrowers' circumstances. For example, prepayments are less common on fixed-rate loans because these loans typically involve fees on prepayments above a certain threshold. In contrast, variable-rate loans – which are the bulk of housing loans in Australia –

do not generally involve prepayment penalties and therefore show higher rates of excess repayment. Decisions to prepay may also be influenced by tax incentives. Owner-occupiers have an incentive to pay down their mortgage ahead of schedule as their interest payments are not tax deductible: in effect, the post-tax return to prepaying these loans equals the mortgage rate. Investors, by contrast, do not have the same incentive to make excess repayments given they can negatively gear their property. Consistent with this, over half of owner-occupiers are estimated to be ahead on their mortgage compared with less than 40 per cent of investors, and, of those that are ahead, owner-occupiers tend to have larger buffers.

The share of owner-occupier households that could be considered to be most vulnerable, that is, with both high debt-servicing ratios (DSRs) and high loan-to-valuation ratios (LVRs), was quite low at around 2½ per cent in 2010 according to data from the latest HILDA Survey (Graph B4). The measure of debt servicing used here covers actual repayments made by households and includes excess repayments; more than one-third of these households are ahead of schedule on their mortgage. For these borrowers, this would suggest that their high DSRs are largely voluntary and that they are therefore less vulnerable to falling into stress. ↘

Graph B4
Households with High LVRs and DSRs*
Share of households with owner-occupier debt



* Households with loan-to-valuation ratios above 80 per cent and debt-servicing ratios greater than 50 per cent
Source: HILDA Release 10.0