GOOD NEWS FOR BORROWERS TRAPPED IN THE 'MORTGAGE PRISON'

In recent times, many borrowers who initially secured home loans at lower interest rates have been facing challenges in meeting the regulatory requirements necessary to refinance their loans at current market rates. This predicament is primarily attributed to the stringent changes in the serviceability buffer, which has become more stringent since the pre-pandemic era.

Understanding the Serviceability Buffer

The serviceability buffer acts as a safety net for potential interest rate increases throughout the loan's term and any unforeseen fluctuations in the borrower's income or expenses.

Lenders are obligated to incorporate a serviceability buffer while determining the borrowing capacity of individuals to ensure they can comfortably make repayments, even if interest rates rise or their circumstances change.

The Australian Prudential Regulation Authority (APRA) recommends a buffer of 3%, meaning lenders assess whether a borrower would be able to meet repayments comfortably if the interest rate on the loan were 3 percentage points higher at the time of loan approval.

Calculating the Serviceability Level

Lenders calculate the serviceability level by deducting all monthly expenses from the after tax monthly income, resulting in a figure known as net income surplus. They then compute the net service ratio by dividing the net income surplus by the cost of the borrower's monthly debt commitments.

Background Information

In July 2019, the Australian Prudential Regulation Authority (APRA) proposed changes to its guidance on serviceability assessments performed by authorised deposit taking institutions (ADIs), that include banks and lending institutions, for residential mortgage applications. The updated guidance eliminated the requirement for ADIs to assess home loan applications using a minimum interest rate of at least 7%, with the common industry practice being 7.25%.

Instead, lenders gained the flexibility to determine their own minimum interest rate floor for serviceability assessments and use a revised interest rate buffer of at least 2.5% over the loan's interest rate.

In 2021, APRA raised the minimum serviceability rate buffer from 2.5 to 3.0 percentage points, citing the

substantial household debt as a major factor in their decision. This adjustment affected borrowers, particularly first home buyers, as owner occupiers applying for loans with interest rates above 5% now needed to demonstrate the ability to make repayments even if interest rates rise to over 8%, while investors must meet repayments above 9%.

Implications and Challenges

As interest rates have risen, some individuals have found themselves trapped in a situation commonly referred to as “mortgage prison,” where their income has not kept pace with higher loan repayments. Those who took out home loans when the cash rate was at 0.1% may now surpass the stress test applied at that time due to the increased cash rate exceeding the 3% serviceability buffer.

In some instances, lenders applying a 3% serviceability buffer on top of the current higher interest rate could disqualify several borrowers from refinancing their loans, effectively leaving them stuck with their existing loan and interest rate.

Positive news for borrowers

Fortunately, there has been a recent announcement from major lenders that they will assist home loan borrowers trapped in “mortgage prison” due to stringent regulatory standards. These lenders have indicated a reduction in their serviceability buffer to 1% for eligible borrowers who have not missed any repayments in the past 12 months and possess a certain level of equity in their property. Of course every lender is different and borrowers may be subject to the lender’s terms and conditions meaning not all borrowers will qualify.

Consequently, homeowners who were previously ineligible may now have the opportunity to refinance their loans at lower interest rates.

Relief for borrowers

If you have faced loan rejection in the past 12 months, we may be able to find a lender willing to refinance your loan or work with you to explore suitable solutions.

Whether you need to free up cash for a renovation, consolidate debt or seek a better interest rate, we can assist by searching the market for a solution tailored to suit your needs.

Lenders are striving to make refinancing more accessible for individuals who would otherwise be confined in the “mortgage prison,” and there are still competitive options available.

Simply reach out, and we will take care of the groundwork on your behalf.

Make sure you read our article **‘Unlocking the secrets to a stellar credit score’**