

The great Australian nightmare: mortgage default and repossession

MORTGAGE DEFAULT HAS LONG TERM IMPACTS ON THE FINANCIAL WELLBEING OF HOUSEHOLDS INCLUDING BANKRUPTCY, DRAWING ON SUPERANNUATION SAVINGS, AND HIGH LEVELS OF DEBT EVEN AFTER THE SALE OF THE HOUSE. BETTER ACCESS BY BORROWERS TO FINANCIAL ADVICE AND MORTGAGE RELIEF ASSISTANCE, AS WELL AS STRICTER LENDING STANDARDS AND BETTER CONSIDERATION OF ILLNESS AND HARDSHIP BY LENDERS, WOULD REDUCE RATES OF DEFAULT.

KEY POINTS

- In March 2010 the Reserve Bank of Australia estimated that 27 000 households are in arrears (90 days or more behind on mortgage repayments) compared with an estimated 23 000 at the end of 2008. While this is a more modest increase than predicted during the economic downturn, underemployment and rising interest rates may still have a negative impact on rates of arrears.
- The main triggers of mortgage default include loss of income, excessive debt and high interest rates. However, personal circumstances, including accidents, illness and divorce are also significant. Usually a combination of these factors leads to loan default—a *perfect storm* phenomenon.
- Households use various strategies to prevent the loss of their homes when they are unable to meet repayments. The most common responses of those surveyed involved taking on more debt—borrowing on credit cards (40%) or from family or friends (38%) and refinancing their loans (21%). Only 24 per cent sought financial advice.
- Default can have long term impacts: 42 per cent of households remained in debt after the sale of their house and the level of debt was dependent on how quickly a household acted when they got into arrears (the sooner they acted, the less debt they accumulated).

*This bulletin is based on research by **Professor Mike Berry, Professor Tony Dalton and Dr Anitra Nelson** of the AHURI RMIT Research Centre. The research examined the nature and causes of mortgage default in Australia, and its social and economic impacts.*

- Independent financial advice for borrowers, particularly those taking out their first loan, can help to reduce the incidence of mortgage default. Borrowers who seek advice early on when they experience repayment difficulties have more options and suffer less severe long term consequences than those who wait.

CONTEXT

Mortgage default is the chronic incapacity to meet mortgage repayments and can lead to the sale or repossession of the dwelling. Available figures on mortgage default do not reveal how many households resolve their difficulties by making amends to the lender, refinance or avoid repossession by voluntary or forced sale of their homes.

The sub-prime crisis in the US has starkly illustrated the connection between housing and broader economic factors. In Australia, mortgage stress has become more visible in the wake of the long boom in housing markets in many regions, especially capital cities. Strong demand for housing, its limited supply, and easily accessible credit have seen household debt levels rise over the last decade, as housing affordability has dropped. This leaves many Australian households vulnerable to interest rate rises and unemployment, or underemployment. The economic correction caused by the global financial crisis has left many lower and middle income households exposed. The number of households in *severe mortgage stress*, that is, in arrears, trying to sell or refinance, or facing foreclosure will depend on how much unemployment/underemployment increases and how high interest rates rise.

RESEARCH METHODS

The research identified the broader risks to the housing system and economy of mortgage default and established what kinds of policy interventions might reduce the incidence of mortgage default in Australia. To better understand the main factors responsible for borrowers falling into mortgage repayment difficulties, and the range of impacts this has on their lives, this study involved a questionnaire survey of 87 people who faced possession orders in NSW and Victoria in late 2008. Follow up telephone or face to face interviews were held with 27 mortgagors who had experienced difficulties paying

their mortgage and were in arrears or default. Key actors in the legal, advice and advocacy sectors were also interviewed. The research drew on a range of additional sources including: government inquiries, Supreme Court records of possession in New South Wales and Victoria, and industry market research.

KEY FINDINGS

Circumstances of households experiencing repayment difficulties

The survey households who had faced claims of possession from major lenders were similar to most Australian households. They expressed familiar motivations for becoming home owners, including security, pride and freedom. Their ages were evenly spread between 35–54 years and they earned low to moderate incomes. Defaulter households generally had high initial loan to value ratios (LVRs), paid relatively high interest rates and were more likely than the total population of Australian home purchasers to borrow from sources other than banks—more than one third had done so. Defaulters were also more likely to have established a loan through a mortgage broker. This connection may be circumstantial. However, concern that brokers encourage borrowers who are not in a strong position to take on loans is indicated in the data.

Couples with children were the most common household type to default on their mortgage. This is consistent with findings from Wood and Ong (2009, p.26) that show couples with children are the group most likely to experience sustained affordability stress. Relationship breakdown is implicated as both a cause and an outcome of mortgage default, although it seems it is more often a cause. The survey showed significant changes in household composition between the time of purchase, and the time of the claim for possession. There was a decrease in couple with children households (from 46% to 24%), and a rise in other household types, especially single parent households (from 10% to 16%). As an interviewee explained:

See, I wasn't living in the house for quite some time. And I just kept telling the bank that look, I know it's half in my name, but I don't live there anymore. And they were basically saying to me well that's bad luck, you're still

on the title. I said I want to get off the title and they said you can't unless you sell it.

Triggers of mortgage default

For those interviewed, the descent into mortgage default was triggered by a mutually reinforcing combination of factors coming together, a *perfect storm* phenomenon. Personal circumstances, such as an illness or accident in the household or relationship breakdown, often play a role. These circumstances interact with other triggers. The most common reason for missing mortgage repayments among those surveyed was loss of income, followed by higher than average interest rates and too much debt. Initially underestimating the cost of monthly repayments and other housing costs was also a trigger. Because the causes of missing mortgage repayments are multiple and connected, it is often difficult to distinguish the primary cause of mortgage default.

Household responses to repayment difficulties

The household survey indicated a range of initial responses to the inability to meet mortgage repayments. The most common responses were taking on more debt or more expensive debt by borrowing more from either credit cards (40%) or family and friends (38%). Significantly, only a minority (24%) of severely stressed mortgagors surveyed sought independent financial advice on budgeting and other ways to solve the problem. Households (21%) also refinanced their homes to achieve a better balance between income and repayments. In some cases (14%) household members took on extra work to earn more income and meet repayments.

Households (30%) also took a range of other actions to prevent foreclosure when they fell into arrears, including drawing on superannuation investments to prevent the loss of their homes. Although half of the survey respondents attempted to vary the terms of their existing mortgage to address repayment difficulties, only 4 per cent succeeded.

Long term consequences of mortgage default

The majority of households surveyed were in the process of dealing with claims of possession, so the survey results did not provide data on final outcomes

for the majority of those surveyed. Nevertheless, where possible, the survey did provide data.

As indicated above, 21 per cent of households' initial responses to the inability to meet repayments were to refinance—89 per cent refinanced for a higher amount to consolidate debts, and many had done so more than once. As one person interviewed indicated:

I had a \$12 000 extension so [I could] get rid of all the excess bills that I had and the rest of the money was there for repayments and what money I had I just kept putting into it.

Banks may charge a risk premium on interest rates to mortgagees who are in arrears, which can serve to delay and entrench existing repayment problems and increase the remaining debt after the sale of the home.

A key finding was that where the house had been sold, 42 per cent of people were left with a debt. The size of the debt depended on the local property market and how quickly they acted when they got into arrears. Generally, the sooner they acted the less debt accumulated.

Defaulters overwhelmingly seek to avoid declaring bankruptcy, although this is an option. This option can preserve the long term interest in having superannuation. As one respondent put it:

We've been placed in this situation that we can't get out of and the only way to do that is to go through the bankruptcy courts because otherwise we would be liable for \$250 000 which we don't have ... the solicitor did suggest that Michael use his super to pay off that. I said "come on, what are we going to live on?" That's all we've got left is Michael's super. That's for the rest of our lives, for the next 20 years or something, if we live that long.

There are regulations that will allow the Australian Prudential Regulation Authority (APRA) to approve the release of superannuation funds when the person faces the 'forced sale of their principle place of residence' and 13 per cent of households did this. Financial counsellors and APRA have expressed concerns that this may only be a *band aid* solution that only benefits lenders.

POLICY IMPLICATIONS

With mortgages increasing in size and duration, unforeseen circumstances such as unemployment, illness and separation are more likely to challenge mortgage holders. Fujitsu Consulting estimates that in 2010 the number of households in severe mortgage stress could exceed 250 000.

Following the 2007 *House of Representatives Inquiry into Home Lending Practices and Processes*, the Federal Government has initiated a number of important reforms, including a national system of regulating all residential mortgage lenders and improvements to the external dispute resolution (EDR) processes between mortgagor and mortgagee. This research project supports a number of other avenues for possible policy development, including:

- Requiring borrowers to apply stricter criteria for assessing debt-servicing capacity to address predatory lending.
- Requiring comparable and plain language information on all loan products.
- Ensuring that (re)possession cannot be instituted while EDR and other appeal processes are in progress.
- Providing free and easily accessed independent financial advice to mortgagors who fall into arrears, as well as mandating such advice prior to taking on a loan.
- Expanding eligibility for mortgage relief assistance and making it consistent nationally, and targeting assistance to those low to moderate income households more likely to be exposed to sustained mortgage stress, such as families with children.

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- Redefining hardship criteria to recognise how prolonged illness within a household constrains mortgage debt repayment capacity.

At a more general level, two key implications can be drawn. First, there is a need to provide more accurate and relevant information on mortgage products and the risks and consequences of default need to be made clear to potential mortgagors prior to loans being taken out. Second, a better functioning, more efficient private rental market would reduce the real and perceived imperative of Australian households to access home ownership at almost any cost or risk.

FURTHER INFORMATION

Fujitsu Consulting (2009) *Anatomy of Australian mortgage stress August 2009 Stress-O-Meter update*.

Wood and Ong (2009) *The dynamics of housing affordability: movements in and out of housing affordability stress 2001-2006*, AHURI Final Report no.133.

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