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Take Control - With Your Independent Financial Adviser

How to handle a mortgage rate rise

Hands up if a jump in your monthly home loan repayments would cause financial pain? If your hand is flapping in the breeze, it could be time to act. With mortgage interest rates on the rise the sooner you stress test your finances the better.

After a period of historically low interest rates, the big four banks have begun to increase their standard variable home lending rates. This is in response to rapid growth in investor property lending, booming house prices and regulatory changes that require banks to set aside more capital to cover potential losses on their housing loans.

The turning point in the mortgage interest rate cycle appears to have been in October when the four major banks lifted their standard variable rates by an average of 0.18 percentage points to around 5.6 per cent. And in a new trend, rates for investor housing loans have been lifted even higher. For example, Commonwealth Bank's variable investment home loan rate rose to 5.72 per cent.

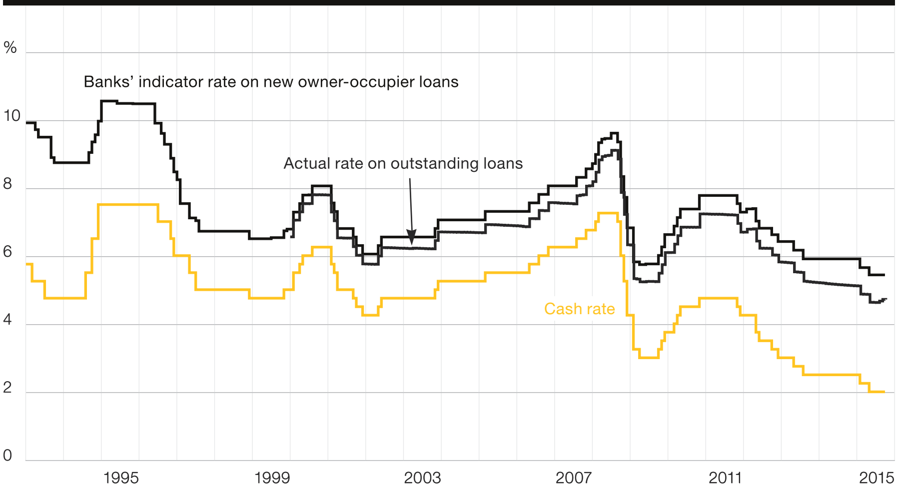
Of course, these are headline rates. Most banks offer discounted and package rates while some smaller lenders are offering standard variable rates below 4 per cent.

Rate gap widens

In fact, the gap between the big four and other mortgage lenders is getting bigger. A year ago the average variable rate offered by the big four was 0.25 percentage points higher than the rest, now the gap is more than double that at 0.53 percentage points.[i]

The gap between mortgage interest rates and the Reserve Bank cash rate is also widening. As the graph shows, the banks' have begun lifting mortgage rates while the cash rate has been steady at 2 per cent since May.

Australian Housing Lending Rates Average interest rate on variable – rate loans



Sources: ABS; APRA; Perpetual; RBA

These latest rate rises will be felt most keenly by recent home buyers. Rising property prices have pushed the size of the average mortgage to $367,000.

So what's a poor borrower to do?

Shop around

Something all borrowers should do on a regular basis is to shop around for a competitive home loan interest rate. With as much as 1.6 per cent between the highest and lowest rates in the market at the moment, the savings can be substantial.

For example, on a $300,000 25-year home loan you could save $276 a month by switching from a rate of 5.6 per cent to 4 per cent. Sometimes all it takes is a phone call to your current lender to negotiate a lower rate.

Stress test your loans

How would your budget cope if rates were to rise to 6 per cent or higher? Trying to forecast interest rates is a mug's game, but it's always wise to stress test your finances for a possible increase in rates.

Look at your current mortgage rate and use an online calculator to find out what your repayments would be if your rate rose by one per cent. Most lenders have a calculator that will allow you to do this.

If the result would cause financial stress, then it's time to put some strategies in place.

Pay more than the minimum

Even though rates are on the rise, they are still close to their historic lows. Any extra cash you can tip into your home loan now will serve as a buffer when the interest rate cycle turns.

If you can afford to pay more than the monthly minimum repayment, you will not only build a financial buffer but reduce your mortgage debt at the same time. That's because extra repayments reduce the amount you are charged interest on.

The good news is that the majority of Australian borrowers already do just that. Westpac alone reported that 73 per cent of its home loan customers were ahead of schedule at the end of 2014.

Fix/split your loan

If you are already financially stretched to the limit, or you simply want the certainty of knowing what your future repayments will be, then it could be time to fix all or part of your mortgage.

Even though variable rates are on the rise, fixed rates have been fairly stable. According to Mortgage Choice, the best 3-year fixed rates in the current market are just above 4 per cent.

Some people prefer to have a bet each way and split their loan between fixed and variable rate components. There are several reasons for taking this approach. There is often an exit fee for terminating a fixed rate loan early and they are less flexible than variable rate mortgages.

For example, if you think rates may go down in the next few years, or you value having a redraw facility, it's a good idea to keep part of your loan at a variable rate of interest.

With interest rates still at or near their historic lows and the banks under pressure to shore up their capital, the next phase of the interest rate cycle is likely to be up. Whether you already have a mortgage or you plan to buy a property in the near future, it pays to be prepared.

If you would like to discuss the impact of a rate rise on your debt repayment strategy, give us a call.

i 'Not all lenders mortgage rate are the same', Clancy Yates, The Age, 11 Nov., 2015

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