Being a Guarantor

Is it right for you?

home loans made clear

Buying a first home is an exciting milestone, but the biggest hurdle for many first-time buyers is the difficulty of saving a deposit. It is now more common than ever before for hopeful young home buyers to turn to family for help to explore the idea of becoming a guarantor.

If you are considering this option, it's important to understand what's at stake before you commit to the decision.

This fact sheet covers the most commonly asked questions we encounter, including what other options may be available.

What is a guarantor?

A guarantor is someone who agrees to provide equity or security for a loan that is not in their name, usually for an adult child or close family member. The guarantee works by using part of the equity in the guarantor's own property as security for the loan, with a mortgage registered against the title of the guarantor's residential property.

Whilst the guarantors are not signing up as co-borrowers on the home loan, if there is a default on the debt and the property is sold due to a foreclosure, the lender can also call on the guarantor to cover the shortfall. This is a very short, simplistic explanation of how guarantees work, and we strongly encourage all guarantors to seek independent legal advice to ensure they fully appreciate their obligations and the potential risks prior to venturing down this path.

How does a guarantee help?

The 2 primary benefits are:

1. Guarantors allow buyers to enter the property market with either a minimal or no deposit of their own.
2. Guarantors allow buyers with a small deposit (i.e. less than 20% of the purchase price) to enter the property market without incurring the additional costs associated with a Lenders Mortgage Insurance (LMI) premium

The guarantee allows the borrower to lend up to the entire cost of the property plus the associated purchase costs – some lenders allowing a total loan equal to 105% of the purchase price - without a deposit.

There are also a few lenders who will allow the borrowers to consolidate other debts like credit cards or car loans into the home loan. But beware - we find that this is not always the most advisable strategy and there are many additional factors that need to be discussed if considering this option, least of all the historical financial discipline and conduct of the borrowers.

Our experience is that most borrowers entering into a guarantee arrangement usually have some level of savings to contribute to the purchase, which in turn reduces the exposure for the guarantor. In these situations, the guarantor will top up the equity position ensuring that the total borrowings are below the magic 80% LVR (Loan to Value Ratio) threshold that ensures they avoid any LMI premium.

How long does a guarantor arrangement last?

We normally advise guarantors to expect to be committed to this arrangement for approximately 5 years, although there are many factors that can impact this time frame and it can vary considerably. The two conditions that have the greatest bearing on this time frame are growth in property values and the amount of additional or principle repayments made on the borrowers' loan.

If as a guarantor your circumstances dictate that you need to be released earlier, in many cases this is possible, subject to the level of equity that has accumulated in the borrower's property. In these situations, there is the option for the borrower to refinance the loan to release the guarantors and if the LVR happens to still be greater than 80%, they would incur an LMI premium.

Who can be a guarantor?

Most commonly, the parent/s of one of the borrowers become guarantor. However, some lenders use a more liberal definition of the term 'guarantor' than others and even allow siblings the option of becoming a guarantor. A few lenders also require the guarantor to prove that they are still in employment or can service the repayments on any residual debt, in another way.

If you're considering agreeing to be a guarantor, talk to one of our brokers early in the decision-making process to obtain current advice on which lenders might be suitable, as credit policy frequently changes.

What are some of the risks and other impacts to consider?

Before you make the decision, here are some of the possible risks and constraints you will be accepting:

POSSIBILITY OF LOSING YOUR HOME

> If your offspring fail to meet repayments, the bank has the right to sell your property to make up any shortfall if the loan is foreclosed on. This is an extreme measure and one lenders like to avoid if possible, but it is the harsh reality associated with guaranteeing a debt.

> If there is trouble with the loan, the lender will, in most cases, sell your child's property first to recover the debt.

> There will also be plenty of advance warning before harsh actions like this are taken, with generally 3 – 6 months' worth of demands being made by the bank before they start the foreclosure process. This early notice should ideally provide sufficient time for all parties to consider alternative options.

IT MAY AFFECT YOUR ABILITY TO OBTAIN OTHER HOME LOANS FOR YOURSELF

> By using up some of your equity, it could diminish the capacity to leverage your home/asset for other property or investment purchases.

> The guarantee can also potentially tie up some of the income available for your own borrowing capacity, reducing your ability to take on additional debt.

RESTRICTIONS ON YOUR ABILITY TO MOVE

> Because your property is acting as the bank's security for another loan, it adds an additional layer of complexity if you decide to upgrade or downsize your home. While it won't prevent you from selling, it will add a few more steps and delays when transitioning between properties.

CHANGES TO THE RELATIONSHIP WITH YOUR CHILDREN

> Remember that by becoming a guarantor you are placing a significant level of trust in the borrowers' financial discipline and reliability.

> If they do encounter difficulty with the loan, how will that impact the mood at the next family gathering? Make sure you discuss the "negatives" the "what ifs" and the "exit timeline" early in the conversation and before committing to the guarantee.

> Are you also prepared to provide the guarantee for other siblings, and if not, how will that impact the family dynamic?

How can you reduce the risk?

If you do decide to go down the guarantor path, there are a few strategies we recommend to minimise the risks.

TALK IT OUT FIRST

> Discuss with the borrowers the importance of staying on top of their repayments and if there are difficulties or issues, that they identify and act on them early.

> Ensure the borrowers are acutely aware that they are putting at risk your retirement and future at a point in time when you are much closer to the end of your working life than they are, with less opportunity to recover from any financial misstep.

CONSIDER DEBT MANAGEMENT

> Ensure they're making principal & interest repayments, this will help the borrowers repay their home loan balance faster than if they were to make interest only repayments, putting them in a better position to release the guarantee sooner.

> Manage their property purchase price expectations and keep loan repayments at a manageable level. A smaller loan will mean a bigger surplus in their savings account at the end of each month.

> Focus should be on building equity fast. If they have the capacity to make additional repayments above the minimum, set this up early as the positive impact on accelerating the home loan principal reduction is significant. By having additional repayments sitting in the loan that can be accessed via a redraw, they will have an in-built buffer and safety net that can be drawn upon in lean times, or if their income temporarily reduces, e.g. if deciding to start a family.

IMPRESS UPON THEM THE NEED TO TAKE OUT PERSONAL INSURANCE

> More than 75% of all property foreclosures occur because a borrower becomes sick or injured and just can't work, it's rare that borrowers just give up on a home loan repayment. Having the security that money will be available if there is an extended period where they can't work will help reduce the chance of one of the common triggers that causes a bank to call in a loan.

> Because the borrowers are putting you at financial risk as well as themselves, our internal policy is that we encourage the borrowers to take out "Income Protection Insurance" as a minimum. Use the milestone of a home purchase as a catalyst to assess what cover they already hold (possibly in their superannuation fund) and/or what cover they should put in place.

SEEK INDEPENDENT LEGAL ADVICE

> By independent, we mean consulting a different solicitor to the one that is managing the conveyancing process to ensure there is no conflict in the advice they provide.

> We recommend that you speak with a legal expert sooner rather than later to ensure you fully understand all the risks and obligations associated with the guarantee. It is best to have had that conversation well in advance of the borrowers having their hearts set on a particular property, just in case you are not comfortable with the arrangement.

What other ways can you help your kids buy a home?

Perhaps you have decided not to enter into a guarantee after all, but you still want to help. Here are some alternate options:

PROVIDE A GIFT OF A CASH DEPOSIT

> This option removes the risk associated with encumbering your property, even if you draw out funds from your home loan, the overall amount at risk can be reduced with many lenders able to approve loans with as little as a 5% deposit.

> Offer a co-contribution on their savings plan, for every dollar they save you chip in a dollar of your own.

PROVIDE A LOAN FOR THEIR DEPOSIT

> You could take out a loan against your own home in your own name and then on lend those funds to the borrowers.

> The arrangement could be that they meet the repayments on your bank loan dollar for dollar including the interest.

> Another option is to make it interest free for them and accept repayment of the debt if/when they eventually sell their home.

> In these examples we would recommend consulting with your solicitor to consider the option of drawing up an official loan agreement.

BECOME A CO-BORROWER AND CO-OWNER

> By owning a small share of the property, you also receive the long-term benefits of accumulating equity as the home increases in value. Note: this option could exclude the buyers from being eligible for any First Home Buyer government incentives.

LETTING THEM MOVE BACK HOME

> If rent payments are making it too hard for your children to save for a deposit, consider fitting out the garage for them to move into.

> Living with you can dramatically decrease their overheads and allow them to accumulate the deposit faster.

Speak to the experts

Our brokers are happy to help you understand all the options related to parents providing financial support for their children.

Please call to arrange a time for a confidential chat either with, or without the borrowers' present.

Unlike many of our competitors, the Mortgage Brokers at Clarity Home Loans are all paid a salary and don't earn any commissions from the banks, so we'll never try and talk you into a lender or situation that isn't the right match for you. With over 2,500 loan products to choose from, we can offer you a range of options to suit your specific goals.

Give the office a call or send an email to set up a consultation - we are also more than happy to answer any preliminary questions you may have over the phone.

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