Using a Guarantor to help you buy a home

Is it right for you?

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Buying your first home is an exciting milestone, but it's not always simple. Faced with the hurdle of getting a deposit together, it's now more common than ever before for hopeful young home buyers, like yourself, to turn to family for help, in some cases asking a family member to explore the idea of being a guarantor for them.

If you're considering this option, it is important you understand what is at stake before you ask a family member to commit to becoming a guarantor.

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 new loan, with a mortgage registered against the title of the guarantor's property.

Whilst the guarantors are not 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 borrowers and guarantors to seek independent legal advice to ensure they fully appreciate their obligations and the potential risks prior to venturing down this path.

How can a guarantor help you purchase a home?

The 2 primary benefits are:

1. A Guarantor can assist your entry into the property market with either a minimal or no deposit of your 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 you to borrow 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 any savings or holding a deposit of your own.

There are also a few lenders who will allow you 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 additional financial burden or risk imposed upon the guarantors.

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 you avoid any LMI premium.

How long does a guarantor arrangement last?

We normally advise guarantors and borrowers 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 principal repayments you make on your loan.

If the guarantor wants to be released earlier, in some cases this is possible, subject to the level of equity that has accumulated in your property. In these situations, there is the option to refinance your loan to release the guarantors. If the Loan to Value Ratio (LVR) happens to still be greater than 80%, you would incur a Lenders Mortgage Insurance (LMI) premium.

Who can be a guarantor?

Most commonly, it is a parent/s who will 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 asking a parent or sibling to be a guarantor when you buy a home, 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 the risks for the guarantor?

Before your guarantor makes their decision, here are some possible risks and constraints they will be accepting.

POSSIBILITY OF LOSING THEIR HOME

> If you fail to meet repayments, the bank has the right to sell not only your home, but also the guarantor's property to make up any shortfall if the loan is foreclosed on.

RESTRICTIONS ON THEIR ABILITY TO MOVE

> Because their property is acting as the bank's security for your loan, it adds an additional layer of complexity if they need to move homes. While it won't prevent them from selling, it will add a few more steps and delays when transitioning between properties.

IT MAY AFFECT THEIR ABILITY TO OBTAIN FINANCE FOR THEMSELVES

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

> The guarantee can also tie up some of the guarantor's income, which could reduce their borrowing capacity if wanting to take on additional debt to buy another property.

CHANGES TO YOUR RELATIONSHIP

> Remember by becoming a guarantor your family members are placing a significant level of trust in your financial discipline and reliability.

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

> Are they also prepared to provide the guarantee for your 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 your guarantor that you understand the importance of staying on top of your repayments and if there are difficulties or issues, provide comfort that you will identify and act on them early.

> Acknowledge the risk you are putting on their retirement and financial future at a point in time when they are much closer to the end of their working lives than you are.

FOCUS ON PAYING DOWN YOUR LOAN FAST!

> Ensure you're making principal & interest repayments, this will help you repay your home loan balance quicker than if you were to make interest only repayments, putting you in a better position to release your guarantor sooner.

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

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

TAKE OUT INCOME PROTECTION 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 you can't work, will provide some additional comfort for your guarantors.

> Because you are putting your guarantor at financial risk as well as yourself, we encourage you to take out "Income Protection Insurance" as a minimum. The milestone of purchasing your first home is a great chance to assess what cover you already hold (possibly in your superannuation fund) and consider what level of cover you should put in place.

ENSURE THE GUARANTOR'S OBTAIN INDEPENDENT LEGAL ADVICE

> It is our company policy to hold a private conversation with your would-be guarantor/s to make sure that they understand their decision and that they don't feel pressured.

> We strongly suggest that they seek independent legal advice, by independent we mean consulting a different solicitor to the one that is managing your conveyance process, to ensure there is no conflict of interest.

What other ways can a family member help you buy a home?

Perhaps you or your would-be guarantor have decided not to enter into a guarantee after all, but they still want to help.

Here are some alternative options:

A GIFT OF A CASH DEPOSIT

> This option removes the risks associated with encumbering your guarantor's property. Even if they draw the funds out of their home loan, the overall amount at risk will be reduced as many lenders are able to approve loans with as little as a 5% deposit.

> Set up a co-contribution on your savings plan, for every dollar you save they chip in a dollar of their own. Discuss super contribution schemes and savings plans.

PROVIDE A LOAN FOR YOUR DEPOSIT

> Your would-be guarantor could take out a loan against their own home, in their own name and then on-lend those funds to you.

> The arrangement could be that you meet the repayments on their bank loan, dollar for dollar including the interest.

> They may offer to make the loan interest-free for you and accept repayment of the debt if/when you eventually sell the home.

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

ASK THE GUARANTOR TO BUY THE PROPERTY WITH YOU AND BECOME CO-BORROWERS AND CO-OWNERS.

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

LETTING YOU LIVE AT HOME.

> If rent payments are making it too hard for you to save for a deposit, they could consider fitting out their garage for you to move into.

> Living with family can dramatically decrease your overheads and allow you to accumulate your deposit faster.

Speak to the experts

Our brokers are happy to help you understand all the options. Give us a call to make a time to chat.

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 product 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.