
Parental guarantee for first-home loans good value

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With property prices declining over recent months, the balance of power has shifted from property sellers to buyers. And a buyers market is perfect for first-home owners as they tend to be on a tight budget and are relatively inexperienced.

Despite a slight easing in affordability due to a fall in property prices, like many parents I appreciate how difficult it is for younger people to get into the property market. Thankfully, parents can do many things to help.

I have often said that the first property someone buys is probably the most important property they will acquire in their lifetime. The reason is that, if they buy well — that is, a property that generates a strong level of capital growth — the positive, compounding wealth effect will greatly assist future financial endeavours such as upgrading and investing. Therefore, as parents, we can educate our children about the importance of buying an investment-grade asset with strong fundamentals.

With the new comprehensive credit reporting regime in place since July, first-time buyers need to be careful with their financial management in the years leading up to purchasing their first property. The banks will now have access to a lot more data and history that they will use to score a borrower's credit worthiness.

Things like applying too often for credit cards or personal loans, late bill payments and having high credit card balances will affect their ability to get a mortgage.

In the past, banks never had access to this information. All borrowers had to do was demonstrate their ability to save over a period of only six months to qualify for a loan. This meant people who had a history of being relatively (financially) undisciplined could improve the appearance of their creditworthiness by knuckling down and saving for six months. This is no longer be possible.

There are two main considerations to determine whether someone is ready to buy their first home. First, do they have enough deposit? Most lenders require a deposit of at least 5 per cent of the property's value. Plus, there will be acquisition costs such as stamp duty, mortgage insurance and legal fees, which can easily account for another 5 per cent.

Second, do they have a consistent surplus cash flow after the payment of living expenses to meet the proposed loan repayments (including a buffer for interest rate increases)?

As parents, there is little we can do to help with surplus cash flow other than to counsel our children on basic cash-flow management. However, when it comes to a deposit, often parents can provide very valuable assistance. Often, not having a large enough deposit is the main barrier for a first-home buyer. Parents can help in a couple of ways, such as providing a gift or co-owning property with their children, but these tend to have many pitfalls.

In our experience, the best way to help your child on the deposit front is by allowing them to use the equity you have in your property. You can do this by offering a limited security guarantee (often referred to as a family guarantee).

Assume your child would like to purchase a property for \$600,000. They have \$30,000 of savings and the acquisition costs are, say, \$10,000. Therefore, they need to borrow \$580,000. As this loan amount exceeds 95 per cent of the property's value, no bank will approve a loan of his size. A solution is for you to provide a limited guarantee of \$125,000. This increases the bank's total security to \$725,000 for a loan of \$580,000, being 80 per cent. This means your child does not need to pay lenders mortgage insurance — a once-off fee that typically costs 3-4 per cent of the loan amount. That's a big saving. A family guarantee also maximises your child's borrowing capacity and helps them get into the market sooner.

Apart from the requirement for you to get independent legal advice, providing this limited guarantee doesn't really cost you anything. And when your child's property appreciates in value and/or the loan balance reduces, you can ask the bank to release the guarantee. In our clients' experiences, parental guarantees have been short term. I don't recall any that were in place for longer than five years.

This is not without risk. If your child defaults on the loan and the bank sells their property and there's a shortfall, you will be liable (although your liability is capped at the guarantee amount).

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