To guarantor or to gift?

The devil is in the detail

The current softer property prices are bringing more first home buyers (FHBs) to the market – the highest level since 2010[1]. With lenders recently increasing interest rates and higher costs of living compared to current wage growth, can FHBs go it alone?

Many Australians now believe that first home buying is still out of reach for many. Even with the recent smaller property price tags, higher prices over the last decade meant FHBs have sometimes required larger deposits (depending on the Loan to Value Ratio) and taken longer to enter the property market.

Research reveals the biggest hurdle FHBs face is saving a sufficient deposit[2].

Gift or loan? The devil is in the detail

For parents helping out their children in the property market, it is important to know the difference between a gift and a loan.

The characteristics of a true loan are:

- The existence of a loan agreement
- The terms of repayment
- It states whether interest is payable
- Genuine expectation of repayment
- Documented timing of repayments
- Security provided in respect of the loan
- Exit strategies considered and documented

The list above does not need to be 'ticked off' entirely but you would expect details, consistency and practical implementation of repaying the loan.

Case study – Judge rules "This IS a loan!"

Let's call him Gary. Gary was in a seven year de-facto relationship with Sarah and they have three children together. Gary's dad made available $290,000 from the equity of his home to help with the purchase of their family home. Gary and his dad did the right thing by investing in a formal loan agreement drawn up by their solicitor.

The agreement had clauses and recognised that Gary had previous debts and that he was making regular repayments. These repayments were recorded and documented including the interest component associated with the loan.

On separation, Sarah claimed that there was no loan agreement and she knew nothing about it hence it should not be considered as part of the settlement.

Well, the judge's decision was 'This is a loan!' Good thing is that Gary's dad differentiated between a loan and a gift by having the written loan agreement.

Asset rich but cash poor?

Many parents or grandparents are asset rich but cash poor. Going guarantor can be a more likely option for some than to gift or loan.

A guarantor allows the equity in a property to be used as additional security for another person's loan.

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Another reason many buyers use a guarantee or gift is to keep the borrowing ratio to 80% and therefore avoid paying lenders mortgage insurance.

Research by Core Data states that more than one fifth of FHBs under the age of 30 use a guarantor to obtain a home loan. Of the FHBs who purchased a property using a guarantor, 77.2% said that their parents were their guarantor[3].

The biggest difference between a loan and a gift versus guarantor is that there is NO monetary exchange – the parents use the equity in their property to help their child into the property market by acting as a guarantor to the lender for their loan.

Beware – if the FHB defaults on their loan, the guarantor becomes responsible for paying their debt[3].

In the event of the FHB defaulting, the lender is obligated to first sell the FHB's property and only have recourse to the guarantor for the short fall. Also, most guarantors provide a limited guarantee to the lender to protect themselves from material losses.

If your child is unable to meet the terms of the loan, ask yourself:

- Could you afford to meet the repayments if they can't?
- What impact might it have on your own credit report?
- What impact will it have on YOUR future loans?
- Could there be any impact to your family relationship?
- What is the exit strategy if things go bad?

Talk to us so we can step you through the guarantor process or devise the best strategy for your family.

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1 Domain: House Price Report, June Quarter 2018

2 & 3 Core Data, Evolving Great Australian Dream 2018