What You Need To Consider Before Cosigning On A Loan

February 5, 2019 - According to information published by the National Association of Realtors this week, last year roughly 21% of new home mortgages required the signature of a co-signer. Co-signers may be friends, relatives or event business acquaintances who are acting with the best of intentions. Unfortunately, most people who agree to co-sign on any form of loan don't really understand the ramification of what they are doing or how it could potentially impact them in the future. Here are some of the things you need to consider.

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When you co-sign for a loan, you are entering into a legal agreement with the lender. You are making the commitment to repay the borrowers loan in the event the borrower defaults. If that happens, your credit will be impacted. And depending upon the type of loan, you may even be in a position to be sued by the lender to recover their money.

Unlike the borrower, co-signers usually have no ownership interest in what they are co-signing for. If it's a home mortgage, you're obligated to make payments if the borrower doesn't but you don't have an ownership interest in the property they purchased. That means you can't foreclose on the property. The same is true for a car loan. In a scenario where the borrower defaults and you pay off the loan, you can't then take the borrower's car. If you do that, you can be arrested for grand theft auto.

And once you've co-signed on a loan, you're likely to be on that loan for its life. In the case of a home mortgage, that could be for 30 years unless the borrower refinances at some point or sells before then. That's a long time. You're relationship with that borrower may be fantastic today, but 30 years is a long time. You may not be speaking to each other by that time (and if they default on the loan, that's probably a very safe bet).

Banks and lenders are in the business of making money, and they do that by lending and managing money. When a borrower is told they need someone to co-sign with them for a loan, the bank is really saying that they think there is a high probability that the prospective borrower won't be able to repay the loan. Just think about that for a minute. And then think about the person you are considering co-signing for.

Maybe that person is your child who is just trying to establish credit, and you want to help him out. If that's the case, there are other ways to do this without co-signing. For instance it might be safer to apply for a joint credit card that both of you have access to. That will also give you the ability to cancel the account in the event your child decides to go on a wild spending spree.

On the other hand, maybe the person asking to co-sign is a family member who has had financial problems in the past. Do you really want to tie your credit to that person? Regardless of how uncomfortable it will be to say "no" when you're asked to co-sign, that will be nothing compared to how uncomfortable you'll be if they stop making payments on the loan. And the statistics say that your chances of getting burned when co-signing are significant.

A 2016 study by CreditCards.com revealed some startling statistics. According to their survey roughly 18% of American adults have co-signed for loans and 1 in 4 co-signers lost money as a result of co-signing. 28% of respondents said that their credit score was impacted by co-signing. And 26% said that their relationships with other people (meaning the primary borrower and those associated with the borrower) were negatively impacted. Bottom line is that there is a very real chance you'll lose money and friendships by co-signing.

If you're in a position that you're absolutely committed to co-signing for a loan, then there are some things you can do to protect yourself.

First, insist on looking at the primary borrower's finances yourself. That includes looking at their credit report (not just their credit score). If that report shows a lot of delinquencies, walk away. If you are co-singing on a mortgage, insist that their lender use an impound account for taxes and insurance. Do this even if the borrower can be exempted from an impound account based on their down payment amount. This will ensure these items are never the reason for a potential foreclosure.

For larger loans, take out a term life insurance policy on the borrower naming you as the beneficiary and insist that the borrower make the premium payments.

You may also want to consult with an attorney to ask about structuring a written agreement between you and the borrower that covers what will happen in the event of a loan default. Again, insist that the borrower pay for your attorney's time.

The time to address the risks of co-signing is before you actually sign. Understanding those risks and how to mitigate them could be the difference between helping someone out and having a mess on your hands sometime down the road.
byJim Malmberg
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