Section 4

Guarantees and additional security

Introduction

Sometimes lenders are reluctant to lend solely on the basis of accepting the property as security. They require something more – and that something may be the support of a guarantor or surety.

A **guarantor** is someone (whether an individual, a company or occasionally a partnership) who agrees to be responsible for the repayment of a loan if the borrower cannot, or will not, repay it himself. He does this by making a *guarantee*, which is defined under the Statute of Frauds Act 1677 as a written undertaking to 'answer for the debt, default or miscarriage of others'.

A **surety**, on the other hand, is a guarantor who, in addition, puts up some form of security for the mortgage. As well as undertaking to answer for the mortgage if the borrower fails to do so, he also provides some additional collateral.

Section 4 explains how lenders might take additional security, including: guarantees and sureties; life assurance; collateral deposits; and mortgage indemnity guarantees. The section also outlines the principal fees involved in property purchase.

Section 4 covers parts 3 and 4 of the syllabus for Unit 4.

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4.1 Guarantees and sureties

Typically, **guarantees** are taken from parents on behalf of their son or daughter's borrowing. Frequently, the directors of companies are asked to give their personal guarantees to secure a loan made to the company because a loan made to a company is enforceable only against the company, not its shareholders and not normally against the directors. Undertaking to guarantee the loan ensures the support of the directors.

In some cases, those who give guarantees are asked to support their guarantees with some form of security, eg their own home, or stocks and shares that they own: this then makes them *sureties*.

A lender must exercise great care in how it takes guarantees. On the one hand, it will want to be sure that it does all it legally can to ensure the guarantor pays; on the other, it must be careful to prevent the guarantor from being able legitimately to avoid his obligations.

A major risk to guard against is that the guarantor might argue that the guarantee is invalid because he did not receive adequate explanation of the terms or that undue pressure made him sign it. Without fail, lenders should advise guarantors to seek independent legal advice from their own solicitor and then check that that has, in fact, been done.

Steps should be taken to ensure that prospective guarantors understand what they are taking on. This is important for the guarantor – who may find that he incurs a substantial liability. It is also critically important for the lender, who will not wish to find that a guarantee on which it has been relying has been made invalid because the guarantor has managed to show that he was unaware of, or did not understand, what the guarantee meant.

There are a number of specific issues that can render a guarantee invalid, as follows:

- *lack of capacity to contract*: as, for example, where the guarantor is a minor with no legal capacity to contract or where the guarantor is a company with no powers to give guarantees;
- *undue influence*: this may simply by virtue of the nature of the relationship between the guarantor and the borrower. Undue influence is where one party is dominant over another and can persuade them to do something they probably would not otherwise do. Examples of relationships where undue influence might be demonstrable would include parent and child, doctor and patient, or solicitor and client;

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- *misrepresentation*: where the terms of the guarantee were misrepresented to the prospective guarantor – whether because of negligence, fraud or accident;
- *misapprehension*: where the prospective guarantor is under an incorrect impression about the nature and effect of the guarantee. If the lender becomes aware of this, it has a duty to correct the misapprehension or it may find itself liable for misrepresentation – as was the case in *Lloyds Bank plc v Waterhouse* [1991];
- *mistake*: where the guarantor can show that he has not understood the nature of the document being signed;
- *duress*: where the guarantor has been forced, perhaps by way of physical threats, to sign the guarantee document.

In *Barclays Bank plc v O'Brien* [1994], the plaintiff was able to prove that the guarantee she gave to support her husband's borrowing was invalid due to misrepresentation and undue influence, and that she had not been advised to seek truly independent advice.

This case led to the inclusion of a provision in the Banking Code that demonstrates that lenders encourage prospective guarantors to seek independent legal advice before entering into a guarantor contract. This is now an established feature of lending practice in all cases where guarantors are involved. If you have not already done so, obtain a copy of the Banking Code, and, if your organisation has one, its own summary document of its obligations under the code, and familiarise yourself with the matters relating to giving advice to guarantors.

The lender has the right to enforce the guarantee should the borrower default in repayment. By contrast, the guarantor has few rights. A request can be made for release from the obligations of the guarantee agreement, but the lender will only agree to this if it is felt that the lending proposition is now sound without it.

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4.2 Additional security

The lending institution has two 'safety nets' whenever it enters into a mortgage contract:

- the promise to repay the debt contained in the legal charge or standard security;
- the value of the property as security for the loan.

In the UK it is customary to offer relatively high percentage mortgages, often 90–95% of valuation. Some lenders even consider 100% loans in some circumstances, but other lenders may only lend more than 80% of the property's value if some form of additional security is made available.

Check to see if there are any circumstances under which your own institution will offer 100% mortgages.

4.2.1 Life assurance policies

Some ***life assurance policies*** accumulate a surrender value after a period of time in force. These typically include endowment assurances. Generally, endowment policies have no surrender value at all for an initial period eg 18–24 months, but tend to increase in value after that time as reversionary bonuses are added.

It is possible for a lender to take such policies into consideration as additional security. The method of taking a policy of assurance as security is by *assignment*. This is the legal method of transfer from the insured to the lender.

Some lenders take a deposit of the life assurance policy document rather than a deed of assignment and so save time. This gives the lender no legal right to the proceeds of the policy but does create an equitable right. An *equitable right* is governed by the practice of equity, or fairness, and indicates an agreement between the two parties.

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4.2.2 Collateral deposits

A ***collateral deposit*** is simply a sum of money placed with a lender, or an account assigned to a lender, used as additional security for a loan. The funds are effectively 'frozen' until the debt is repaid or until the debt is reduced to a level at which the additional security is deemed unnecessary.

Where that collateral deposit (or indeed security in any other form, such as shares, another property, etc) is put up by someone other than the borrower, then the depositor will be known as a surety. The mechanics of how the lender would perfect his security over the assets is beyond the scope of this text but there are fairly standard procedures that generally give the lender recourse to the collateral without reference to the surety, should the borrower default and the need arise.

4.2.3 Mortgage indemnity guarantee premium

The mortgage indemnity guarantee (MIG) is payable by the borrower through a single premium. The premium protects the lender against losses caused by the borrower defaulting and the lender having to take possession and sell the property. Although the charge is paid by the borrower, the mortgage indemnity guarantee does not actually benefit him, except that, without it, he would not be able to borrow such a high amount.

Some lenders do not buy an insurance policy but take the charge as a way of offsetting the potential risk.

In recent years, more and more lenders have either dispensed with higher lending charges or paid the mortgage indemnity guarantee themselves.

If a claim is made by a lender on a MIG policy, the insurer will pay out the shortfall, up to the limit insured less an excess, which is usually 20% of the amount claimed. The insurer is entitled to exercise its *right of subrogation*, which means it can sue the borrower for recovery of the amount paid to the lender. The insurer is able to insist that the lender exercises prudent underwriting methods.

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Example

If a lender sells a property in possession for £120,000 but the total owed by the former borrower is £130,000, then the claim made by the lender on any MIG would be for £10,000, less the £2,000 excess.

The insurer will probably sue the borrower under its right of subrogation for the £10,000 that it has paid to the lender.

4.3 House-buying fees and charges

The main fees and charges relating to buying a house have been covered in the appropriate sections of this text but it is useful to bring them together at this stage.

4.3.1 Estate agents

Estate agent's fees are paid by the vendor once the sale has been completed, and typically amount to a figure of between 1.5% and 3% of the sale price, depending on whether the agent has sole selling rights or a joint agency. Most agents have a no sale, no fee agreement.

4.3.2 Mortgage fees

- *The reservation (booking) fee* is payable when the borrower wishes to take advantage of a special deal – a fixed rate mortgage, for example. Typical fees range from £100 to £300 and, in some cases are refundable if the mortgage does not go ahead.
- *Arrangement fees* are charged by some lenders on some or all of their mortgages. The fee can be as low as £50 and as high as £300, depending on the particular mortgage. In many cases, the arrangement fee includes a basic property valuation.
- Where the loan-to-value ratio exceeds a certain level, the lender may charge a **higher lending charge** that, in many cases can be added to

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the loan. The charge threshold varies from lender to lender but is usually between 75% and 90%. The lender may use the higher lending charge to buy a mortgage indemnity guarantee.

Example

A mortgage applicant is hoping to borrow £72,000 to purchase a property priced at £84,000 but valued at £80,000. The lender requires a higher lending charge if the loan-to-value ratio exceeds 80%.

The higher lending charge threshold is £80,000 x 80% = £64,000.

The amount of the advance to be covered by the charge is therefore:

£72,000 – £64,000 = £8,000.

If the higher lending charge rate is 4.5%, the premium will be:

$$\frac{£8{,}000}{100} \times 4.5 = £360$$

- *The mortgage indemnity guarantee premium* is used by some lenders where the loan-to-value ratio exceeds a stated amount and is paid for by the higher lending charge. It is payable on completion as a single premium and is often added to the loan; it cannot be refunded or taken to another property.
- The existing lender may charge a *small lender's reference fee*, typically £20–50, to supply the new lender with a reference in relation to the conduct of the existing account.
- If the borrower uses a mortgage broker to arrange the mortgage, the broker is able to charge a *broker's fee*, which must be stated clearly in the broker's initial disclosure document. The fee is most commonly a fixed charge, although some brokers charge a percentage of the mortgage advance, for example 0.5%, especially for non-standard cases. In addition, the broker may receive a *procuration (finder's) fee* from the lender.

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4.3.3 Valuation and surveys

Typical costs of valuation and survey for a £250,000 property are:

- valuation only – £250–300;
- homebuyer's report – £450–550;
- full building survey – £600 or more, depending on the size and age of the property. The price of the property is relatively unimportant.

Valuations and surveys are not refundable once completed.

4.3.4 Legal fees

Legal fees are difficult to quantify because they are affected by a variety of factors. Typical activities generating charges are as follows:

- *local authority searches* – carried out before exchange of contract and not refundable once completed. Typical fees vary from £75 to £130. These searches identify plans for new roads and developments;
- *Land Registry search* – typical cost £5 to £10;
- *environmental searches* – carried out before exchange of contracts and not refundable once completed. They check for a history of flooding, mining subsidence, radon gas and so on. A typical fee is £39;
- *electronic transfer fees* for transferring funds on completion. A typical fee is £30 plus VAT;
- *bankruptcy searches* – carried out before exchange of contracts and not refundable once completed. These are carried out to ensure that the buyer is not an undischarged bankrupt and typically cost £5 to £10;
- *Land Registry fees* – payable after completion of the sale to register the property in the new owner's name. The fees range from £40 for a property sold for £50,000 or less to £700 for a property sold for more than £1m;
- *solicitor's/conveyancer's fee* – paid on completion to cover the legal work carried out during the purchase process. If the sale does not complete, some solicitors will reduce their charge, particularly if they are asked to carry out another purchase. Many solicitors now charge a flat fee, regardless of the property value;

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- *title indemnity fees* – the title indemnity is required where the title cannot be fully guaranteed. It protects the lender and owner from ownership claims made by others. The fee is typically 0.10% of the property value.

4.3.5 Stamp Duty Land Tax (SDLT)

Stamp Duty Land Tax replaced stamp duty on property from December 2003. It is largely a technical change, in that Stamp Duty is a tax levied on the transfer documents, while Stamp Duty Land Tax is levied on the physical transfer of the property. Stamp Duty Land Tax is paid by the purchaser of a property on transfer from the vendor. The tax is calculated on the full price of the property.

The tax is levied on a sliding scale, determined by the sale price of the property. The rates are:

- 1% is levied where the price is more than £125,000 but no more than £250,000;
- 3% is levied where the price is between £250,001 and £500,000;
- 4% is levied where the price is more than £500,000.

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Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 4. Review the text if necessary.

Answers can be found on page [4] 96.

1. Sally has been asked to stand as guarantor for her son George's mortgage. What are her obligations and what should she be advised to do?

2. What is the purpose of the Mortgage Indemnity Guarantee?

Answer true or false to the following statements.

3. A guarantor promises to make someone else's loan repayments if they are made redundant.

4. An item of security put up by a guarantor is known as a surety.

5. Guarantors must seek independent legal advice about the obligations of providing a guarantee.

6. The borrower pays the premium for a mortgage indemnity guarantee policy, even though the policy is not for his benefit.

7. Mortgage indemnity guarantee policies normally only pay out 80% of a lender's loss.

8. Where a lender makes a higher lending charge, it must use it to purchase a MIG.

9. A reservation fee will be charged on the majority of mortgages.

10. Bankruptcy search fees are non-refundable.

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Answers

1. Sally will become responsible for the mortgage if George defaults. She should be advised to seek independent legal advice before agreeing to provide the guarantee.

2. A mortgage indemnity guarantee protects the lender in the event of the borrower defaulting on the mortgage. It will pay the lender the shortfall between the sale price and the outstanding mortgage in the event that the lender takes possession on default. The insurance company has the right to sue the borrower for any money paid out in this situation.

3. ***False***: a guarantor promises to make the repayments if the borrower is unable to do so for any reason.

4. ***True***: a surety occurs when a guarantor puts up some security.

5. ***False***: guarantors must be advised to take independent legal advice.

6. ***True***: the mortgage indemnity guarantee policy indemnifies the lender if they have to repossess and sell the property at a loss.

7. ***True***: most mortgage indemnity guarantee policies have a 20% excess.

8. ***False***: the lender is not under any obligation to use a higher lending charge to purchase a MIG.

9. ***False***: a reservation fee usually applies only to special deals.

10. ***True***: bankruptcy search fees are non-refundable.

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