Obligations when signing or cosigning a loan

Reports on Credit — Issue 3

Agreeing to pay back a loan or credit card charges involves more than a handshake. Lenders require you to sign a legally binding contract, whether it's for a dining room table bought at the local furniture store or your dream home financed by the nation's largest mortgage company. All lenders spell out exactly what they expect in return for borrowing money. This issue of *Reports on Credit* answers these important questions:

- What are your responsibilities when you open a credit account?
- What might happen if you don't meet those obligations?
- What responsibilities do you have when you cosign for a friend or relative?
- How might a cosigned account affect your ability to obtain new credit?
- Should you cosign?
- What about other account associations?

What are your responsibilities when you open a credit account?

Don't forget that credit involves a legal contract. Although each contract differs, all have specific requirements for payment amounts, interest rates, due dates and late payment penalties.

Credit contracts commonly require you to own, pay taxes and keep insurance on any item (such as a car or home) that might have been used to obtain a secured loan.

You're also required to notify the lender of a change in your name or address.

What might happen if you don't meet those obligations?

Meeting the exact terms of the account adds value to your credit history. Each month, lenders report account balances, which accounts were paid on time, which accounts were paid late and which accounts weren't paid at all.

If you fall behind on your payments, your credit report — which acts as your credit references — will suffer, you likely will pay late fees, and you'll have a harder time getting new credit in the future. Even if you catch up on your payments, the late payments still will be reported as part of your credit history.

If you fail to pay a debt, most lenders will sell the account to a collections agency that will continue to attempt to collect the amount you owe, plus additional fees and interest.

The lender also has the right to sell your collateral if you default on a loan. Collateral is something of value, such as a car or home, that you offer as security for your loan.

In some cases, selling the collateral will not produce enough money to pay your debt. In that case, you may be required to continue repaying the loan even though you no longer own the item.

Defaulting on a loan includes failing to make payments, falsifying information on a credit application, not having insurance on the collateral, using the collateral for illegal purposes, allowing another lien on the collateral or declaring bankruptcy.

What responsibilities do you have when you cosign for a friend or relative?

Cosigners lend their names and good credit histories to the primary borrower. If the primary borrower dies, loses a job or otherwise fails to make payments, all responsibility for meeting the terms of the account transfers to the cosigner.

An often-overlooked aspect of cosigning for an account is the fact that the account appears on both the primary borrower's and the cosigner's credit reports.

If the primary borrower doesn't pay, the lender might notify you to make the payments. However, it is your responsibility to ensure the payments are made each month, even if the lender does not contact you.

How might a cosigned account affect your ability to get new credit?

Even if it is not delinquent, a cosigned account is part of your credit history. Since financial institutions consider a cosigned loan your responsibility, they'll include it when calculating your debt-to-income and balance-to-limit ratios.

These ratios help lenders judge whether you have too many bills to pay. If the ratios are too high, your application might be denied or your interest rate increased — even when the primary borrower never misses a payment on the cosigned account.

Should you cosign?

Parents often cosign for their children who have adequate income but a lack of credit history. By cosigning, parents help their children get the account and, perhaps more important, establish credit in their own names.

Federal regulations do not require you to be related to the primary borrower to cosign a loan, but individual financial institutions may have stricter policies.

Before deciding to cosign consider the following:

- Know the purpose of the account, the type of account, the terms, and why your friend or relative needs a cosigner.
- Establish access to the account so that you can verify payments are being made on time and as agreed each month.
- Understand your legal and financial obligations.
- Read and understand the credit contract. Be aware that a lender may be able to collect from you even when there is collateral. In the case of a car loan, for example, the lender might demand payment from you instead of repossessing the car. Even if the car is repossessed, its value may not be sufficient to pay off the loan.
- Understand that if the primary borrower defaults, the credit grantor can demand payment from you without trying to collect first from the primary borrower. The debt then may include late fees or collection costs in addition to the loan amount.

What about other account associations?

There are a number of ways you may be associated with a credit account that appears on your credit history. Here are a few examples:

- **Individual:** You have sole contractual responsibility for the account
- **Joint Contractual liability:** You have contractual responsibility to pay the debts on the joint account
- **Authorized user:** You may use the account, but another person is responsible for the debt.
- **Co-maker or guarantor:** Also referred to as cosigner, you guarantee the account and assume responsibility if the maker should default
- **Maker:** You are responsible for the account, which is guaranteed by a co-maker or cosigner

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