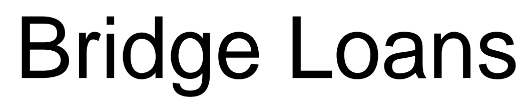

November 01, 2006

Bridge Loans

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Introduction

When you're simultaneously buying and selling a home, you may be faced with the prospect of having to purchase your new home before you've closed on the sale of your present one. This situation may cause you problems. First, you may not have the money for your down payment on your new home until you receive the proceeds from the sale of your current home. In addition, if you still have a mortgage outstanding on your current home, you may not qualify for a mortgage to buy your new one.

There are several ways to deal with this situation, one of which is a short–term financing vehicle called a bridge loan.

Spanning troubled waters

A bridge loan should generally be used only as a last resort, due to the expense and complication involved in getting one. First try to find another method of "bridging the gap." Perhaps you can include a closing–on–sale contingency clause in your contract to buy a new home. Unfortunately, there may be situations where a bridge loan is your only alternative.

> **Example(s):** You decide to sell your present home and "trade up" to a more expensive one. You have only $5,000 saved, so the rest of your down payment will come from the sale of your current home. You put your home on the market in April. On May 5, you sign a contract to sell it, with the closing scheduled for July 10. Less than a week later, you find the perfect new home in the neighborhood you want to live in, so you make an offer to purchase. It's accepted, but there's a problem––the seller must close the deal by June 25. You can't buy the new property until you've closed on the sale of your present home, and the buyer of your present home can't move up the date for the closing.

How a bridge loan works

Generally, bridge loans work in one of two ways: by substituting one debt for another, or by piling one debt on top of the other.

The substitution variation

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This variation is most often used when your income and/or debt ratios won't support two traditional mortgages. Under this arrangement, you take a bridge loan against the total value of your present home. Part of the bridge loan proceeds is used to pay off your existing mortgage on your present home, and the remainder is used to fund the down payment on your new home. You'll then need to get a mortgage on the new home for the remainder of the purchase price. As part of the agreement, the same lender that gives you the bridge loan may insist on also being the lender for the mortgage for your new home.

The lender under this arrangement will have security interests in both your current home and your new one. You'll be making two monthly mortgage payments (one––usually of interest only––on the bridge loan and one on the mortgage for your new home) until you close on the sale of your current home. At that time, the proceeds from the sale will be used to repay the bridge loan.

Example(s): Your current home is selling for $160,000, and you have a remaining mortgage balance of $100,000. Your new home has a purchase price of $250,000. Your qualifying ratios are within the parameters a mortgage lender expects, but your income is considered insufficient to support two traditional mortgages. However, the lender will give you a bridge loan if you'll also take the mortgage for the balance of the purchase price on your new home from the same lender. You agree to this arrangement. Your bridge loan is for $155,000; you use the proceeds to pay off the mortgage of $100,000 on your current home and to make a $55,000 down payment on your new home. The same lender also gives you a mortgage of $195,000 to cover the balance of the new home's purchase price.

The lender places security liens on both your current home and your new home. You make regular payments on your mortgage for your new home and interest–only payments on the bridge loan. When your current home sells, you use the proceeds to pay off the bridge loan. You're then left with $5,000 from the sale and only the mortgage on your new home.

Piling on the debt

This arrangement is most often used in the event that your income and qualifying ratios would support two traditional mortgages, but you have no down payment funds for your new home until your old one is sold. In this variation, you take a bridge loan against the equity in your current home and use the proceeds to fund the down payment on your new home. The bridge loan is secured only by a second mortgage lien on your current home. At the same time, you obtain a mortgage on the new home for the balance of its purchase price. While the lender that gives you the bridge loan might be happy to give you this mortgage, it may not be a requirement for getting the bridge loan. This leaves you free to shop around for the best deal you can get on the mortgage for your new home.

Until your current home sells, you would be making three mortgage payments: one on your existing mortgage on your current home, a second on the new mortgage on your new home, and a third (usually of interest only) on the bridge loan. When your current home does sell, the proceeds of the sale will be used to pay off your existing mortgage on that property and the bridge loan you took out to obtain your down payment on the new home.

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Example(s): Your current home is selling for $195,000. Your remaining mortgage balance is $60,000. Your new home has a purchase price of $275,000. Your income and qualifying ratios are such that you can support your existing mortgage on your current home and a mortgage of $210,000 for your new home. Your problem is that you don't have the difference of $65,000 ($275,000 – $210,000) for the down payment on your new home until your current one sells. All you've got in cash is $15,000. If you don't act fast, you'll lose the new home you want.

You find a different lender that is willing to give you a bridge loan of $50,000 against the equity in your present home. With the proceeds of this loan, you can fund the down payment you need to purchase your new home. When your current home sells, you pay off the existing mortgage of $60,000 and the bridge loan of $50,000––and have $85,000 ($195,000 – [$60,000 + $50,000]) of the sale proceeds left over. You may use this money to reduce the principal balance of the mortgage on your new home, thus increasing your equity, or you may consider alternative investment opportunities.

The terms and conditions of a bridge loan

- The actual term of the loan will vary depending on your lender, but it will seldom be longer than six months. If need be, you may be able to renew the loan for another six months.
- Because a bridge loan is almost always held by the lender, and not sold on the secondary market, it often carries a high interest rate (comparable to that for a home equity loan) and may be available only as an adjustable rate loan.
- During the term of the bridge loan, you generally must make payments only on the interest.
- Bridge loans generally don't include a prepayment penalty, and you should not agree to one that does.

Drawbacks of bridge loans

Affordability

Since you'll be making payments on your bridge loan while you're still paying on at least one mortgage (and sometimes two), you may not have the cash flow you need to afford a bridge loan. In such circumstances, rather than require monthly interest payments on the loan, the lender may let the interest accrue, allowing you to delay payments until you close on the sale of your current home. This will solve your cash flow problem, but it won't make the loan any less expensive. In fact, it will raise the cost of the loan, since you'll end up paying interest on the accrued interest.

Qualification standards

Because bridge loans are expensive, you may have difficulty qualifying for one. Lenders want to be certain that you'll be able to handle all the mortgage payments you'll need to make or, if they allow

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the bridge loan interest to accrue, that you'll have the funds to pay off the bridge loan in full when you sell your current home. This means that the lender wants to see substantial equity in your current home. The lender will also want to be quite certain that any pending sale of your current home will go through.

> **Caution:** If you have not yet signed a contract to sell your current home, it may be extremely difficult to get a bridge loan, unless you secure the loan with additional collateral (stocks, bonds, mutual funds, or the like).

How to make sure you can handle a bridge loan

Because of their short–term nature, the high expenses associated with them, and the fact that they are secured by your home, bridge loans have three major potential dangers:

1. An unforeseen delay on the sale of your current home could require an extension of the term of the bridge loan, placing an additional burden on your overburdened budget.
2. You may not be able to afford the monthly interest payment expense or the final total payment due on the loan.
3. If your current home doesn't sell, the lender could foreclose on it.

It would be in your best interests, then, to make sure that all of the following are true before you take a bridge loan:

- You've already signed a contract to sell your current home with a buyer who has received a mortgage commitment or preapproval.
- You've prepared a careful budget, and you're certain you'll be able to afford the cost of the bridge loan. This budget should factor in worst–case scenarios (e.g., the sale of your current home is delayed or even canceled by the buyer).
- The bridge loan allows you to extend its term if a problem occurs. If your bridge loan doesn't include such a clause, be certain you can pay it off at the end of its term with other funds (e.g., from the sale of stocks, bonds, or mutual funds).
- You've gotten a mortgage commitment from a lender that will give you a mortgage for your new home. This may be easiest to do with the lender offering the bridge loan.

> **Tip:** If you'll get the mortgage for your new home from the same lender offering the bridge loan, try to negotiate the most favorable terms possible on the bridge loan. At the least, include in the contract a clause stating that a portion of any fees paid on the bridge loan will be credited toward fees charged on your mortgage.

Remember that a bridge loan should be your final option. When buying and selling a home simultaneously, always try to coordinate the two actions, or use a closing–on–sale contingency clause to avoid the necessity of a bridge loan.

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