What do we do now?

When our clients (let's call them David and Trish) were contemplating selling their home, they started looking around at other homes on the market – to understand the market and get an indication of the type of properties available to them once they sold.

"We had planned to sell our home and find a new one during the settlement period. Our back up plan was to move in with Dave's brother if we didn't find our dream new home quickly," Trish said. "But plans kind of changed, as plans tend to do.

"While we were looking (just checking out the market really) we found the most perfect home for us, at a really great price. It even had an organic veggie garden, which I had always dreamed of.

"Dave was far keener on selling first than I was, but then I saw this new home and it all fell into place for me. I wanted to sell, fast, and get into our new home.

"What wasn't falling into place were our finances."

Like many people, David and Trish were caught in the financial twilight zone between selling their old home and buying their new one.

"I felt like I wanted to jump into our future, but we were stuck in our past," Trish says.

So David and Trish came to see us to discuss bridging finance as a way of allowing them to purchase a new home before they had actually sold their old one.

They needed bridging finance - Here's how it works.

A bridging loan is a financial product specifically designed for borrowers who want to purchase a new home before the sale of their old one is complete. The loan amount is calculated by adding the value of your new home to your existing mortgage (if there is one). The resulting figure is the amount of your bridging loan, often referred to as your peak debt.

You then pay the interest on the combined total until your home has settled.

In David and Trish's case, the existing debt on their home was $200,000, and the home they wanted to buy was $750,000.

A bridging loan was organised for them to the amount of $950,000 (on which interest is payable while they waited for their property to sell) allowing them to buy their new home before their old home sold.

$200,000 + $750,000 = $950,000

That's the simple version.

In reality, bridging loans can become complicated for a host of reasons.

Qualification

The lender on the current home must be the same as the lender for the new property.

To qualify for a bridging loan, you need to have equity. Generally, it is recommended you have more than 50% equity in your home to make bridging finance work for you.

You must meet serviceability requirements as you would with any mortgage or loan, including evidence of your income, employment status, expenses and other supporting documents.

You will need to have a valuation done on both properties.

Lenders use both properties as security.

Terms

There are two types of bridging loans – open and closed.

An open loan is available to borrowers like David and Trish, who want to buy a new property before contracts have exchanged on the old one.

Closed bridging loans are available to borrowers who have already exchanged contracts on their existing home (no surprise that these loans are easier to approve).

Most lenders who offer bridging finance will loan 80% of the property value. Some will go up to 90%, however these loans are more difficult to qualify for, and LMI (lenders' mortgage insurance) will be applicable.

You may be able to apply for a deposit bond (a guarantee from an insurance company). They cost around 1.2% of the amount of the deposit. A bond for a 20% deposit on a $750,000 property, for example, will typically cost around $1,800.

Bridging loans are generally available for a period of 6 or 12 months on new and existing properties as well as on building projects. Term extensions are sometimes available on a case by case basis.

Every lender has different requirements for servicing the bridging loan. Some require that between the time your bridging loan is advanced and the sale of your existing home, you make interest-only repayments on the peak debt, some require you to immediately start repayments on the proposed ongoing loan, and some don't require payments until the first property is sold (the interest on the peak debt is compounded). In all cases, you still have to prove you can meet the requirements of serviceability for the end debt, hence payslips etc.

After your property is sold, the home loan switches from interest only to principal and interest repayments and the borrower continues to make normal home loan

repayments plus the compounded bridging loan interest on the new loan. Remember you still need to pay government fees on settlement of your new home.

If you don't sell your existing home within the bridging period, many lenders will charge a higher interest rate and ask you to start making principal and interest repayments on the peak debt in order to service both loans.

Bridging loans can be a fantastic tool to utilise in property transactions, however they do come with risks and challenges. So it's important to understand the finer details and structure your loan in a way that suits you while covering the host of variable outcomes that may apply to your situation.

David and Trish were lucky. Their property sold and they managed to purchase their new home at a great price. However, we had structured their loan appropriately and built in buffers to protect them.

Bridging finance – The pros

You can buy your new property immediately.

You have time to get the best price on your old home.

Interest-only repayments mean you are only paying the minimal amount (no principal) while you sell your old home.

You avoid the costs of moving twice, renting or moving in with family.

Bridging finance – The cons

Accurate valuations of the property you are selling are key. Overestimating the sale price can put borrowers in a precarious financial position.

Interest is compounded monthly, so the longer it takes to sell your property, the more your loan will accrue interest.

There may be a higher interest rate applied if you don't sell the property in the agreed timeframe.

No redraw facility is available.

You need to include costs such as valuations, purchasing and selling costs, application fees and, if applicable, LMI fees BEFORE the settlement of your new property.

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