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RMBS Research

How Morningstar Views the Credit Risks Residential Bridge Loans Pose

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Author:

Youriy Koudinov | Senior Vice President | youriy.koudinov@morningstar.com | +1 212 548-6391

Analytical Manager:

Kevin Dwyer | Managing Director | kevin.dwyer@morningstar.com | +1 646 560-4525

Morningstar Perspective

Including so-called bridge loans in residential mortgage-backed securitizations is a relatively new phenomenon. In 2018, only a few unrated transactions backed by such loans entered the market. However, Morningstar Credit Ratings, LLC believes these deals might become more commonplace, as investors and issuers become more aware of these securitizations. As such, we are taking the opportunity to explain the risks involved, some mitigating factors, and how we might address securitizations that include bridge loans.

Sometimes referred to as fix-and-flip loans, bridge loans pose distinct risks to RMBS investors. Borrowers use them when buying, renovating, or rebuilding residential properties in order to quickly resell them or rent them out. In some cases, borrowers may extract home equity by borrowing against the new value.

The key risks include a potentially inaccurate assessment of property value after the renovation, higher-than-expected renovation or rebuilding costs, a potential drop in home prices, and the possibility of a decline in demand for homes. That said, several mitigating factors help offset the risks. These include the borrower's home equity, the loans' short terms (generally under three years), the borrowers' experience in flipping properties, and the alignment of interests between the lender and borrower.

A Different Kind of Mortgage Loan

Borrowers who seek to make a profit by flipping homes often seek out short-term loans to finance their investments. Residential bridge loans differ from conventional first-lien mortgages in several ways. Unlike conventional mortgages that typically mature in 15, 20, or 30 years, most bridge loans typically have a shorter term to maturity, generally ranging from a few months to three years. They may also include one or more term extensions.

Many bridge loans are interest-only balloon mortgages that require only interest payments over the term of the loan and repay the full principal at maturity, whereas most conventional mortgages require the gradual repayment of principal over a loan's term. That's because one aim of conventional mortgages is to provide long-term financing to support homeownership.

Bridge loans generally have higher interest rates than conventional mortgage loans and require borrowers to confirm that the loan is used for a business purpose. Unlike conventional mortgages, where the borrower is an individual consumer, the bridge loan mortgagee may be an individual or a business entity (typically small), such as a limited-liability corporation, a limited partnership, or a trust. Bridge loan lenders are commonly relatively small nonbanking companies with a specialized knowledge of a local real estate market. That said, the issuers of securitizations backed by residential bridge loans may be aggregators that acquire the loans from many lenders in various states.

Unconventional Investments

Like the conventional mortgages backed by residential investment properties, bridge loans are usually backed by unoccupied properties. Also, like other investment property loans, some bridge loans are made to borrowers who plan to rent the properties after renovating or rebuilding them. However, such bridge loans are typically taken out when the mortgaged property requires a renovation or a rebuild before bringing in a tenant, and, as such, a lender requires a borrower to present a renovation plan, which includes a breakdown of the expected costs. Therefore, the repayment of a bridge loan taken out by a landlord depends on the borrower's ability to buy and renovate the property to make it rentable, whereas the repayment of a typical investor property loan generally depends on the borrower's ability to collect enough rent to make the loan payments.

Also, the funds from bridge loans may be generally distributed either as a lump sum, as a series of disbursements with amounts tied to property purchase and renovation activities, or as a combination of thereof, with a large payment to fund a purchase and certain funds for renovation placed in an escrow account.

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Key Credit Risks

Because of their unusual attributes, bridge loans pose several risks to investors in securitizations backed by such loans. The key risks involving the borrower or lender include:

- **Abandonment owing to:**
  - **Rehab Costs Miscalculation** – Problems can occur if the borrower underestimates the amount of money needed to renovate or rebuild a property to increase its market value after the repair. A rising renovation budget may eat into or completely erode the borrower's profits, which, in turn, may increase the borrower's incentive to abandon the property and walk away from the loan without paying it in full.
  - **Property Valuation** – The borrower's profits may drop or evaporate if it overestimates the property's market value after the repairs are completed or the property is rebuilt.
  - **Property Demand** – The borrower may overestimate the demand for the property after the renovation is complete or the property is rebuilt. As a result, it may take longer than initially expected, to sell, rent, or refinance, which might delay a repayment of the loan. Also, a potentially lower demand may require lowering the price to sell the property, which also might reduce the proceeds available to repay the loan.

- **Property Value Drop** - The decline in demand for housing or the fall in home prices stemming from a deteriorating economic environment or rising interest rates may lower the postrepair property value, reduce the funds available to pay the loan, or even force the borrower or lender out of business.

Mitigating Factors

Several factors help to offset some of the risks posed by bridge loans. Although mitigating factors vary based on loan level and property level attributes, they include:

- **Borrower Equity** - All things being equal, a loan where a borrower has more equity, based on a lower loan-to-value, loan-to-cost (of purchase and renovation), or loan-to-after-repair-value ratio is less risky than a loan with lower equity and higher ratios. Borrowers with more equity in the property will have less incentive to walk away from it and default on the loan, even if the property value falls.

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- **Borrower Experience** - All things being equal, a loan to a borrower with more experience in successfully purchasing, renovating, and selling or renting properties is less risky than a loan to a borrower with no or less experience.

- **Short Maturities** - Because most bridge loans generally have a relatively short maturity, ranging from a few months to three years, lenders are often in a better position to assess risks such as falling home prices.

- **Alignment of Interests** - A lender and a borrower have incentives to estimate as accurately as possible the property value and the renovation costs because the borrower seeks to make a profit by monetizing the future home value at the same time as the lender scrutinizes the estimates to minimize the risk of borrower default. This helps to mitigate risks of error in assessing property values and renovation costs.

More Performance Information Can Help Refine Risk Analysis

As the issuance of securitizations backed by bridge loans increases, more historical performance data will become available. This will help refine an analytical approach to assess the risks in such transactions.

To perform a preliminary analysis, Morningstar would begin by taking a similar analytical approach to that for transactions backed by conventional mortgage loans. Having the performance data for bridge loans, particularly the data showing the performance of such loans during an economic downturn, will help refine the loan-level analysis of the recovery rates under various economic scenarios. Until then, we would make conservative assumptions to determine rating levels.

We will seek to evaluate, among other factors, the history of the loan performance, the accuracy of assessment of the postrepair property values and the renovation costs, as well as the accuracy and efficiency of controls over the disbursement and use of the renovation funds. Also, we will assess the strength and continuity of the alignment of interests between the issuer, lenders, investors, and other transaction parties, such as the strength of the representations and warranties framework and the detection and enforcement mechanism to seek potential remedies of a breach. Understanding both the risks inherent in bridge loans and the mitigating factors will be essential to Morningstar's analysis.

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