Should I start paying off my mortgages?

By specialist property accountant **Stephen Fay** ACA

Most landlords mortgage their properties, as this allows more properties to be bought. As mortgage rates are rising currently, it makes more financial sense to repay mortgages – but not always, and not for everyone!

Everyone has different financial views and willingness to take financial risk, and so there is no 'right or wrong' to this fundamental question – just things to think about, to make the right decision for you …

1 Property portfolio size

Repaying existing mortgages while also borrowing for new purchases makes no sense. When building up a property portfolio, mortgaging each purchase makes total sense on the journey to reach a planned portfolio size. So most portfolio landlords start their investing by taking out the maximum value mortgage that each property's yield would allow, to stretch their investment capital as far as possible.

However, interest rates are rising … so borrowing at lower LTVs (loan to value) is more prudent, as lenders price high LTV mortgages generally much higher than lower LTV mortgages.

2 Current cash savings set aside

Landlords must live with financial ups and downs, so having instantly available cash on hand means shocks can be absorbed without having to resort to becoming a forced property seller (property generally being an illiquid asset, so a quick sale normally means taking a hit on the sale price). There are not many property problems that can't be solved by having some cash available. Having £1,000-£2,000 per property as a cash reserve provides peace of mind.

3 Other non-mortgage debts

Most personal loan and credit card interest rates are higher than mortgage rates – these should be a financial priority to repay normally (especially as these are generally capital repayment borrowings, so the monthly payment is higher than interest-only mortgage payments). Although, cheap personal loans and 0% credit cards may be the exception.

4 Building long term wealth

Repaying mortgage debt is a safe and sensible strategy to build equity and long-term wealth. Automatically paying off a mortgage via repayment mortgage requires no effort, it's just 'what you do'. You never get used to the spare cash that an interest-only strategy would provide – your reward is a mortgage free property at the end of the mortgage term, so no interest rate or re-financing worries. Or, paying regular lumps into a mortgage – most lenders allow 10% to be repaid per year – allows mortgages to be repaid over time without the commitment of a repayment mortgage.

5 Less debt means less interest to pay

Less mortgage debt reduces the interest payable, which increases cashflow and profit – obviously! Plus, as lower LTV can mean a lower mortgage interest rate on re-finance, paying off one mortgage at a time can mean more flexibility, as a

mortgage-free property can be used as collateral for bridging finance.

And, as we get older, we tend to want more security. There is also something very satisfying about owning property outright – who is to say that's 'wrong'! It may not be what the next landlord would do, but it's your property business and your decision.

6 Mortgages allow more properties to be owned

If using debt finance is good enough for private equity firms, it's good enough for private landlords! Don't forget the goal of property investing ... to make rental profits and capital gains. Mortgaging property allows more property to be acquired, to generate more rental profits and capital gains.

The goal is to become financially free, not necessarily mortgage free. Most big companies acquire other companies via a mix of debt and equity because they want to preserve cash – the goal of most large companies is not to pay off all their borrowings, it is to strategically use borrowings to build up the business and so make more profit.

7 Capital growth happens regardless of the LTV

How a property is financed has no effect on capital growth – which will happen (or not!) either way. If an investor's main property plan is to see capital growth, it therefore makes less sense to repay debt if it can be comfortably serviced.

8 Are savings better spent elsewhere?

Many landlords have modest property plans (eg, a very common target is to have 10 properties going into retirement age). It may well be that there are better uses for any spare cash, for example, spending on property repairs and upgrades could enable a higher rent to be charged.

All properties need a certain amount spent on repairs just to maintain the property – but could investing in the fabric of the building (windows, roof, boiler, kitchen, bathroom, small structural changes) mean lower future repair costs, higher rents, fewer tenant changes etc?

9 Offset mortgage = best of both worlds

An offset mortgage allows savings to be offset against a mortgage to reduce the interest paid, but allows access to the savings (note: this is guaranteed, unlike some old products where the lender could withdraw the facility on a whim). This allows spare cash to be parked in the offset facility, so less interest paid, but no loss of liquid cash. There are even BTL Offset Mortgages available, eg from Family Building Society, Hinckley Building Society (though most offset mortgages are for homes rather than rental property).

10 Don't give lenders the upper hand – life is unpredictable

It's likely that during a typical 25-year mortgage term there are going to be some issues that could cause a cash shortage. Mortgage lenders usually don't allow capital repayments to be re-borrowed, ie it's a one-way street, other than by actually re-mortgaging the property.

Health issues, unemployment, a failing business or an unlucky streak of voids and repairs, can all put pressure on cashflow, so retaining a good cash buffer should always be a priority.

Summary

Most portfolio landlords maximise mortgage borrowings in the early years, reach a target portfolio size and then face the classic dilemma ... should I pay off my mortgages? For many landlords, repaying more expensive non-mortgage debt, building up a decent cash buffer and investing into the fabric of their buildings, should be a priority over repaying mortgages.

But in a new world of rising interest rates, repaying mortgages lowers interest costs, improves profits and equity, and is a safe way to consolidate a property portfolio and reduce the impact of mortgage rate rises. For most landlords this will involve a mix of some property sales to release equity, plus rental profits, to reduce overall borrowings ... as it is a rare landlord that can put a serious dent in their borrowings by only using rental profits.

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