IS IT WORTH PAYING OFF MY MORTGAGES?

By specialist property accountant **Stephen Fay**

Most residential landlords have mortgages on their properties – this allows more properties to be bought and the leverage benefit of property to be used. But does it make financial sense to repay mortgages in the medium to long term?

We all have different tolerances for financial risk and financial views, so there is no 'right or wrong' answer to this common landlord conundrum. Just things to think about and then make the right decision for YOU!

1. Size of property portfolio

Paying off existing mortgages while also borrowing for new purchases makes no sense. When building up a property portfolio, using a mortgage to buy makes total sense until the planned portfolio size is reached.

Most portfolio landlords start their investing by taking out the maximum Loan-To-Value (LTV) mortgage that they can (capped by the lower of the lender's maximum LTV and the property's yield). This allows the most property to be bought by stretching the investable capital as far as possible.

So where a landlord is in the property journey is a key factor in the decision to pay off mortgages – younger landlords who are still building would be a 'no'; older landlords who are at their desired property portfolio size would be a 'yes', or at least a 'maybe'.

2. Amount of cash reserves

Landlords have to live with financial ups and downs – it is just a reality of being in business. Having immediately available cash on hand means shocks can be absorbed without having to resort to becoming a forced property seller (property 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. As a rough guide, having £1-2k per property as a cash reserve provides peace of mind. Some landlords would regard that as way too much, some as way too little!

For those who may have excessive cash on hand, maybe through a property sale or an inheritance, and who don't want to buy more property, may feel that a good use of the cash would be to save on mortgage interest by repaying some debt.

3. Any non-mortgage debts – credit cards, loans etc?

Personal loans and credit cards interest rates are much higher than mortgage rates; these should normally be a financial priority to repay (especially as they are capital repayment debts, so the monthly payment is higher than interest-only mortgage payments).

Generally, credit cards are about smoothing out peaks and troughs of spending rather than to carry debt on a medium-long term basis.

4. Less debt = more safety

Repaying mortgages is a safe and sensible way to build equity and long-term wealth. There is a balance to be struck between the leverage benefit of mortgaging property versus the risk that a reduction in income means repayments get missed.

Automatically paying off a mortgage via a 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.

It's horses for courses… personally I prefer to avoid the over-commitment of repayment buy-to-let (BTL) mortgages, but like the option to chip away at the debt over the mortgage term. 10% per year is more than enough to achieve that.

5. Less debt = less interest = more profit

Having less mortgage debt reduces the interest payable… an instant, guaranteed, permanent reward! This obviously then increases cashflow and profit (the aim of the game).

A lower LTV can also mean a lower mortgage interest rate on remortgage (on the whole of the debt). Paying off one mortgage at a time can mean more flexibility, as a mortgage-free property can be used as collateral for bridging finance, usually at very short notice (days).

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. BUT! Mortgages allow more properties to be owned = more capital growth?

Using debt is the modus operandi for big private equity firms, so 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. QED.

Arguably, the goal of property investing 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 manage the business as profitably as possible.

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. Many landlords would be wealthier if they had been able to acquire 100% (or more!) LTV mortgages. Many properties provide sufficient yield to support 100% mortgages too.

Arguably, if an investor's main property plan is see capital growth, it therefore makes less sense to repay debt if it can be comfortably serviced from the property's income.

8. Are savings better spent elsewhere?

Many landlords have modest property plans (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, e.g., 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 mortgages offer the best of both worlds!

Offset mortgages allows savings to be 'offset' (credited) against a mortgage debt to reduce the interest paid but with instant 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 liquidity. BTL offset mortgages exist, though they are a bit niche - i.e. available through local building societies rather than the major BTL lenders.

10. Life is unpredictable – don't give lenders the upper hand

During a typical 25-year mortgage term there are going to be some financial issues that could cause a cash crunch – bad tenant, unexpected big repairs, licenses, rent controls, etc.

Mortgage lenders usually don't allow capital repayments to be reborrowed – it's a one-way street – other than by actually remortgaging the property.

Other than direct property-related issues, landlords can suffer health issues, unemployment, a failing business or an unlucky streak of personal costs. All these put pressure on cashflow, so retaining a good cash buffer should always be a permanent priority.

Summary

Maximising mortgage borrowings in the early years of building a property portfolio makes total financial sense and is the norm for the vast majority of landlords.

But once the target portfolio size has been reached… what then? Landlords face a classic dilemma – should I pay off my mortgages? And if so, some or all? Or is there a better use for the cash?

For many landlords, repaying 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. Once those boxes are ticked, then chipping away at mortgage debt becomes more sensible.

In an uncertain world of interest rates, ultimately repaying mortgages lowers interest costs, thereby increasing profits (and builds property equity), and is a safe way to consolidate a property portfolio and reduce the chance that external shocks could cause a financial drama.

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.

Reaching the senior years of a landlord's business life with a low- or no-mortgage property portfolio makes for a more manageable, sustainable, safe position, and in my experience is the ultimate end goal for the majority of residential landlords.

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