Should I repay my mortgages?

By specialist property accountant Stephen Fay ACA

This is probably the most-frequently asked question by property investors. Property is a business with big numbers – and most investors' biggest expense is mortgage interest. Having less mortgage debt means less risk, but how many investors can really make a significant dent in their borrowings? And if they can, should they?

This article considers the pro's and con's of repaying mortgages, risk and tax considerations, and how to arrive at a conclusion that is right for YOU.

Initial considerations

Before any investor should even think about repaying any mortgage, there are a number of other issues to consider:

Have you stopped building up your property portfolio?

If the answer to this is 'No', then there is little point in repaying mortgages, to then in the future borrow back the funds to generate deposits and refurb budgets. In the 'portfolio growth' phase of investing, the focus should be on maximum leverage – and yields that allow that.

If you already have the portfolio size you ultimately want... keep reading!

Do you have a decent cash reserve put aside?

Wise landlords keep themselves 'liquid', in other words, maintain a healthy cash buffer to protect against all that life throws at you as a landlord. There are few problems that can't be solved by having ready cash on hand.

Don't worry too much about the financial return on this cash buffer, this is about being able to fund voids and repairs so that you can 'stay in the game' long enough so that time and capital appreciation reward you.

Smart investors ensure they don't run out of cash – and so avoid becoming 'motivated sellers' themselves!

Set aside around £1-2k per property as a minimum reserve – and, of course, once the reserve has been built up, keep it topped up.

Have you paid off any expensive non-mortgage debt (e.g. credit cards)?

Expensive personal loans and credit cards should be the next financial priority – note I specified expensive non-mortgage debt, as some loans and credit cards can be just as cheap as mortgages.

If the answer to all these questions is 'Yes', then repaying mortgage debt may be for you.

The case FOR repaying mortgage debt

Repaying mortgage debt is a safe and sensible strategy to build equity and long-term wealth.

The following factors are key considerations:

The automatic millionaire

Paying down debt regularly enables mortgages to be repaid without any extra effort, it's just 'what you do'. You never get used to the spare cash that an interest-only strategy would provide – you forego that for the 'prize' of being debt-free in the future.

A repayment mortgage guarantees that you will own the property outright at the end of the mortgage term – which then means no interest rate or re-financing worries.

What will lender underwriting criteria look like in the future? Will the 'highest age possible' reduce so that you can't remortgage if you're older? – and will you have enough equity to repay the mortgages if you are forced to sell? (plus any capital gain tax).

Taking a repayment mortgage provides certainty that your financial future is assured – so you can invest in other things - or even spend some money on toys guilt-free!

Lower debt, lower risk

Reducing debt means less interest payable and higher cashflow and profit. Note that in the short term you are not actually increasing your net worth by repaying debt – you are simply switching cash in the bank for more equity.

Although cash offers ultimate flexibility, unencumbered assets can be used as security for borrowings.

Plus, properties must be unencumbered in order to be transferred into a trust for estate-planning purposes.

Lower debt-servicing costs

Lower debt means less risk for a lender – which means lower finance fees and interest rates, and hence more mortgage choice and better products.

You don't have to switch to a monthly-repayment basis

If you are on an interest-only mortgage, you may want to make lump-sum payments to the lender. This enables you to retain the flexibility to increase, decrease or cease making such payments.

However, you do miss out on the 'automatic' nature of a repayment mortgage – and it's very easy to make excuses NOT to make that scheduled annual lump sum payment!

Remember – it's YOUR property business!

Many investors want to become financially free of a day-job, or to be their own boss, and so 'call the shots'. By all means listen to other investor's strategies, but make the decision that **YOU** feel comfortable with, as there is an emotional element to all business, 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'?

The case AGAINST repaying mortgage debt

How much does your current debt actually cost you?

Pre-credit crunch mortgage liabilities are now more like assets. If you could, how much would you pay to take over (legally, not just via lease option) an attractive tracker mortgage, compared to the current cost of mortgages (with revert rates set by the lenders generally)?

With many mortgages still with 20 years or more to run and with typical pay rates of 1-2.5%, these really are the cheapest rates we will see for a generation (if not ever). So, why would you hand back the gift you have been given?

With offset mortgages, there isn't any need to actually repay mortgages

These days, offset mortgages allow cash savings to be offset against a mortgage balance to reduce the interest payable **WITHOUT** reducing liquidity (being 'liquid' simply means having readily available cash on hand).

There are many residential offset mortgages available, and offset BTL mortgages are now available. Rather than committing to repaying a mortgage in full, remortgage the residential property onto an offset mortgage– and 'park' spare cash into the offset facility.

This means the overall interest payable reduces, with no loss of liquidity. There are even BTL Offset Mortgages available e.g. from Yorkshire Bank.

Many landlords assume that 'repaying mortgages' means trying to pay off 7 or even 8-figure mortgage balances – realistically, this is not likely for the average investor, but just having 1-2 properties on offset mortgages with a decent cash buffer offsetting can mean good extra rental profits, plus lots of liquidity.

With many offset mortgages on 40 year terms, this is a lifetime risk management technique.

There may be a better use of your property profits

Not everyone wants a large portfolio, and so using spare funds to buy more property is not for everyone. However, there may be other options in your property business that may provide a better Return on Investment than saving 5% interest.

For example, spending on repairs and upgrades to your portfolio can enable a higher rent to be charged. Just £2k spent on repair works could easily improve the rent by £25-50pcm – an annual return of 15-30% on funds spent.

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 and higher rents?

Capital appreciation happens regardless of the LTV

Equity in a property has no effect on the appreciation that a property may show – the property may be unencumbered or at 150% LTV – the appreciation will happen (or not), either way.

Given that most investors' primary aim to benefit from capital appreciation over the long term, it therefore makes less sense to repay debt that can be comfortably serviced.

If the property goal is cashflow and equity, what's wrong with modest gearing?

If it's good enough for Vodafone, Manchester United and the venture capitalists, it's good enough for landlords! The purpose of investing in property is to buy property that will generate good cashflow and appreciate in value – **the goal is to become financially-free, not mortgage-free.**

Debt interest is tax-deductible and if income is strong, manageable debt allows a larger portfolio to be developed.

Most big companies acquire other companies via a mix of debt and equity because they want to preserve cash.

You never know what's around the corner!

Unemployment, a failing business, or an unlucky streak of voids and repairs, can all put pressure on cashflow and the cash buffer.

Insurance companies plan their cash reserves with an 'every 100 years' event in mind (volcano, tsunami etc).

But, your mortgage lender is not going to congratulate you for your prudence in repaying capital and happily allow you to re-borrow it on the same terms – nor is the lender likely to want to lend you funds while you are jobless or struggling!

Business is business

Be clear that property investing is business – and in business, logic and reasoning should take precedence over an irrational desire to be mortgage-free.

Hard to do sometimes, but as long as debt is being used as a leverage tool to make more profit, there often isn't a business case to be made for lowering debt below a manageable level.

A final caveat – it rarely makes sense to repay debt where there are repayment penalties payable (usually above a 10% per annum repayment within the initial fixed term).

A word about tax …

It's often said that it is tax-efficient to have mortgage borrowings. On the one hand, it's part of my job to ensure that interest on clients borrowings, as far as possible, is tax-deductible, on the other hand running high debt levels (with corresponding high interest payments) reduces tax only by reducing rental profits.

Striking a balance is required – sailing too close to the wind in order to save tax may cause your property business to fail – so be careful!

In terms of accessing equity – this is a whole new topic – suffice it to say that many landlords spend a lifetime repaying debt – only to then re-borrow the equity back later in life!

For residential property, it's certainly a good tax strategy to release equity rather than sell and crystallise a capital gain.

My approach

As a portfolio landlord, and property accountant, I'm often asked what my own strategy is for managing my property finances – so here it is:

- **Cash ISAs – max these out every year for myself and Mrs Fay (= tax-free savings income).**
- **Current account buffer of 2 months gross rental income.**
- **Residential offset mortgage @70% LTV – fully paid (as interest is not tax-deductible).**
- **One BTL Mortgage Offset account @70% LTV – rental profits are stored here.**
- **Several smaller properties – unencumbered.**
- **No plans to repay any of the 7-figure amount of tracker mortgages held – lenders will receive these funds back at the end of the mortgage term.**

Summary

The decision about repaying mortgages is one that is on the mind of many investors, conscious that the current low interest rate environment will not last forever. For many landlords, repaying more expensive debt, building a cash buffer, investing funds in the fabric of their properties, and using an offset mortgage is a perfectly adequate and sensible strategy.

Other investors with good cash reserves in place, may feel repaying mortgage debt is as good a use as any for their spare cash.

Ultimately, keeping liquid is more important than slightly lower debt – remember only those landlords who can't pay their bills go bust!