A beginners' guide to buy-to-let mortgages

Buying property to let as a long-term investment or to generate a regular income has become an increasingly popular option over recent years, and the demand from would-be tenants for quality rental property continues to grow in many areas of the country.

If you're planning to develop a substantial portfolio as a professional landlord, or you're just thinking of a fairly modest investment for the future you're almost certainly going to need finance. We're ready to help you achieve your goals.

How can you avoid the pitfalls of buy to let and make sure it's a good investment?

There's no such thing as a sure-fire investment and property is no different. But after a couple of difficult years for buy-to-let landlords, the property investment market is busier once again. Many investors have made a good return from buy-to-let property, even during the last couple of years. But plenty of others have lost money. Buy to let isn't an easy option, but you can increase your chances of success if you get some of the basics right.

The property

Many buy to let lenders impose all sorts of restrictions on the property itself so it is important that you check out the viability of lending on the property before agreeing to make an offer.

Properties to be wary of are holiday lets, non-standard construction, agricultural ties, concrete build, high rise flats, ex council properties, timber frame, steel frame, freehold flats, multiple units (bedsits, houses split into flats, Houses of Multiple Occupation), non-standard tenancies, above, below or next to commercial, and the list goes on.

Research the market

it sounds glib to say ‘do your research’, ask yourself who is looking to rent in this area? If it’s young professionals, they’ll want easy access to work (whether that means being near a train or tube station or on a good bus route). If the area is better suited to young families, the priority will be a good school, easy access to shops, off-street parking and/or access to a park or play area.

Would I live here? You shouldn’t necessarily impose your own tastes on the property, but if you wouldn’t live there (because it’s dingy or the furniture is falling apart), why would anyone else?

Be wary of new build. Even before the rise in new-build flat prices a few years ago, many professionals believed that buying a new build flat to rent out was an expensive way of becoming a landlord. Most mortgage lenders restrict the loan to value levels on new build flats.

Arranging your Buy to Let mortgage

These are finance and mortgages that are specifically designed to be used on properties that will be let out in return for a monthly rental income.

Not all lenders offer buy to let mortgages, others do via specialist lending.

Get a deposit.

The mortgage market is pretty difficult for property investors at the moment and you won't be able to get a buy-to-let mortgage without a 15% deposit. However if you can put 25% down you will get a better deal and for every 5% that you can provide above the 25%, your choice of lender will increase while the mortgage rate you have to pay will fall. This is referred to Loan To Value (LTV).

Loan to value is the most that the lender will provide to you based upon the purchase price or value (if remortgaging) of the property.

This determines the level of deposit you require. So if the lender will lend 70% and you buy a property for £100,000 you will require a deposit of 30% i.e. £30,000.

Don't be fooled by the term value; it is extremely rare for any lender to actually lend against value for a purchase. Most will lend against the purchase price with the odd one lending against value or the purchase price whichever is the LOWER.

So if you buy a property for £80,000 but you can evidence that it's really worth £120,000, the lender will still only lend against your £80,000 purchase price.

If you thought getting a mortgage on your home was tough, the buy-to-let market can be an absolute nightmare in comparison! So using the services of an experienced buy-to-let mortgage broker can be invaluable in helping you to navigate through the nuances of different lenders' conditions.

Couple this with the fact that a broker can have access to mortgages you wouldn't be able to get (although conversely, a broker will not have access to some mortgages that are only available if you apply to a lender directly) and the argument for using a mortgage broker becomes even more compelling!

Rental coverage

The key factor of a buy to let mortgage over a residential mortgage is that the amount a lender will lend to you is based upon the value or purchase price of the property versus the rental achievable.

Buy to let lenders are always concerned with ensuring that the property has sufficient rental coverage to meet the mortgage payments so they will use a rental stress test calculation to determine this.

The typical calculation is 125% of the pay rate, variable rate or some other predetermined rate.

To demonstrate, if the pay rate was 5% and you were borrowing £100,000 the lender would want to see a rental of £521 a month to allow that level of borrowing.

£100,000 x 5% / 12 = monthly mortgage payment (£416) x 125% = £521

If your rental is lower than that then, even if the property value is higher, they will still reduce the level of borrowing to meet that rental coverage.

It’s important to note that rental coverage requirements can be significantly higher than this. Lloyds Bank for example use a rental stress of 190% based upon a repayment mortgage; most buy to let lenders are willing to work off interest only payments. Paragon use a stress test of 130% based upon a rate of 7% even though their pay rates are a lot lower than this.

Rental coverage is there to protect you; pay attention to what the numbers are telling you about your deal.

Income requirements

Most lenders will want to know that the rental will adequately cover your mortgage payments but many are also increasingly concerned about investors who are unable to support their lifestyle or cover void periods and maintenance, so most now have an earned income requirement too.

Generally this income will need to be outside of property i.e. rental income or income earned from property development won’t be classed as the primary income. However it can often be used to supplement your income.

A couple of buy to let lenders are very keen to lend to professional landlords and are more flexible with their income requirements BUT lenders do reserve the right to check on your earnings, bank statements, etc if they wish to ensure that you are able to support yourself.

Home ownership

An increasingly important factor in obtaining a buy to let mortgage is being an existing property owner. Some lenders will insist that you own your own home, mortgaged or otherwise.

Some will insist that you have at least one mortgage in your name at application. Others won't mind if you own or rent your own home as long as you own at least one other property. Some lenders will allow a non-property owner onto an application with a property owner and other won't.

Age

Most residential lending is allowed until your retirement usually 65-70 as you will generally not be earning the same money to support a mortgage. Buy to let is different however and most lenders will comfortably allow lending up until your 75-85th birthday and even 90 and beyond.

If you're in your 50s or 60s and find yourself now in a financial position to start building a portfolio you need not fear about not being able to get mortgages. I have clients just starting out in their 70s!

Lending limits

Most lenders will have lending limits which is the maximum number of loans or amount of money they are prepared to lend to you. This is typically two million or 3-10 properties/mortgages. Though as higher limits are reached its not unusual for lenders to reduce their loan to values.

If you are a couple and are buying properties between you it can make sense to buy in individual names to increase your lending allowances. However many lenders still see you as 'connected parties' and restrict your lending according to their normal limits.

Rates

The interest rate payable on your mortgage varies considerably with rates averaging between 3% – 6.5% currently.

The rate payable will typically depend upon several factors:

Lender

Arrangement fee

Type of property

Product term

It's important NOT to simply look at the headline rate of a product.

While this may give you the best cashflow it's likely that the lowest rates have the highest arrangement fees or are over the shortest terms e.g. 1 year fixed and you may have to remortgage all over again in 12 months' time incurring greater costs overall.

I recommend working off around 5% as an average at the moment but remember that rates can and do go significantly higher so always 'stress test' your property and the rent it provides at much higher rates to see who far rates can go before you will struggle to meet the payments.

Interest only or repayment?

Most buy to let lenders will allow you to pay your mortgage on an interest only basis. This has several advantages:

Increased cashflow

Easier accounting

Use today's money to invest further rather than pay down tomorrow's mortgage

But this is very much a personal and commercial decision based upon your own strategy.

There are benefits from going on a repayment mortgage too:

Increasing equity

Reduced risk

Psychological benefit of seeing your mortgage reduce

Having a property with no mortgage on it in the future

Think about how you'll manage the property.

Many property investors forget about the service side of the business. If you're buying to let, you should put as much effort into thinking how you will manage the property as finding it. Check out your tenants yourself. If you're using a lettings agent, don't rely on the checks they carry out. Ask for a copy of a bank statement, references from their employer and a reference from the landlord.

Deposit protection schemes

Tenancy Deposit Protection (TDP) schemes guarantee that tenants will get their deposit back at the end of the tenancy. (However, the tenant is still obliged to meet the terms of the tenancy agreement and must not damage the property.)

Running costs

Repairs you must keep the structure and exterior of the property in a good state of repair. You have final responsibility for ensuring your property is safe and fit for use, and you must ensure that all necessary repairs are carried out properly.

Property maintenance, such as repairs and maintaining the safety of gas and electrical appliances.

Insurance, specialist buildings and contents insurance for landlords is essential. In addition, some insurers will also provide rent guarantee insurance.

Service charges and ground rents for leasehold properties.

Your tenant will normally be responsible for other property related costs such as council tax, a TV licence and utilities. The tenancy agreement should clearly set out who is responsible for each of these payments.

Letting Agent services and charges

If you're new to the Buy to Let market, have several properties, live some distance from your property or you have other demands on your time, it could make sense to use a reputable letting agent. Naturally the fees or commission you pay to an agent will eat into your profit, but it may save you a great deal of trouble. An agent can be a great source of advice, and its worthwhile speaking to local agents who know your area before you buy. A good letting agent will market your property, select tenants, take up references and credit checks, compile inventories and tenancy agreements, collect rent and deposits, and generally inspect and manage the property.

Typical letting agent charges are around 10 to 15% of the monthly rental.

In addition there can be a one-off set up fee. These charges vary from agent to agent, so it may be worth shopping around.

Ending a tenancy

At the end of an Assured Shorthold Tenancy (AST) you have an automatic right as a landlord to possession of your property as long as you've given the tenant two months' notice to vacate the property.

If the notice period expires and the tenant has still not left the property, you will need to start the process of eviction through the courts. You can't forcibly remove a tenant without an eviction order.

If you wish to seek possession under an Assured Shorthold Tenancy because your tenant has not paid the rent, or if they've broken other terms of the agreement, you'll need to use one of the reasons or 'grounds' for possession specified in the Housing Act 1988. You will have to seek independent legal advice on bringing an AST to an end.

Your obligations to the tax man

Tax is payable on the profits you make from letting your Buy to Let property.

It's normally calculated on the gross annual rental income, less any allowable expenses incurred as a result of renting out the property, as well any other allowances that you're entitled to. If you lose money in any one year, you should be able to carry the loss forward and set it against profit you make in subsequent years.

As a landlord, you'll have to submit your rental income on your tax return, so it's vital you keep detailed records of the rental payments you receive as well as all the expenses you incur. It's standard practice for a landlord to employ an accountant to ensure HM Revenue & Customs are properly advised – and to make sure that all allowable expenses are identified so you can offset them against your profit. Although using an accountant will cost money, the fees you pay for the service will be tax deductible, and the help you'll receive could easily save you money in the long run Expenses which can normally be deducted from your income to calculate your profit include: utility bills, insurance, mortgage interest, maintenance and repair (but not improvements), professional fees, cost of services like cleaners and tradesmen and other expenses such as advertising for tenants.

Sale proceeds and tax

If and when you decide to sell your Buy to Let property, the proceeds from the sale will be subject to capital gains tax. Calculating this tax liability can be quite complicated and it's almost certainly worth paying for the expert advice of a qualified accountant.

Further information on taxation and allowances can be found by visiting the HM Revenue & Customs website at www.hmrc.gov.uk