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Mortgage Tips For Buying Investment Properties

Anson Martin

As a mortgage agent, I frequently encounter clients who have an interest in buying an investment property to rent out, but are unsure how to go about obtaining a mortgage for it, and don't know which rules differ from financing an owner-occupied home. There are some similarities, but also significant differences, and with mortgage rules for rental properties changing over the past several years, it further complicates the matter. What applied to a buyer in the past may no longer be the case, and as a result, it can be difficult to know where to start. This article will discuss the process for obtaining mortgage financing on an investment property so you can better determine if it's something you want to look into more closely.

To start with, the type of property first needs to be determined. Most lenders will classify a property with one to four units as residential. Anything more, or if there is a commercial aspect to the property such as a store front, will require commercial financing which is another discussion altogether. This article will discuss residential rental properties. Factors such as credit, income, down payment, property cash flow and expenses will be reviewed by the lender to determine if they will finance a mortgage on it. Let's break down those points in more detail.

Lenders first look at credit. Just like with an owner-occupied home, when buying a rental property, the lender needs to ensure the borrower's credit score and history are sufficient. Even if the property will have a positive cash flow through rental income, if credit is not up to par, lenders will not finance a mortgage. This also helps determine what other debts the borrower has as they would need to be factored into the overall decision.

The next area is income for the borrower. While the property will bring in rental income, lenders will need to see what other income is being generated outside of the rental. This will be discussed in more detail in the property cash flow section, but extra income could be required to offset debts the borrower may currently have. Some lenders will not allow a mortgage if the sole income is from the rents. Income is reviewed in the same manner as for an owner-occupied home, requiring a pay stub and employment letter, or by reviewing taxes for the past two years if self-employed. In addition to income, certain lenders require the borrower to have a sufficient net worth from assets such as savings and investments, or equity in another property.

Down payment is an important factor. The minimum down payment required for a rental property is 20%, much higher than the 5% minimum required for owner-occupied purchases. However, there will be a mortgage insurance premium (with CMHC, for example) added to the mortgage if financing is between 75-80% of the purchase price. Unlike owner-occupied homes, which only require 20% down to avoid an insurance premium, 25% is required for rentals. This can make buying a rental property more of a challenge due to the higher initial investment the borrower will need to come up with, but lenders require this due to the added risk that goes along with financing a property that is not occupied by the owner. A tenant may not care for the property the same way they would for something they own, thus affecting the property's value; similarly, having a property sit vacant for too long may put a strain on making the payments so the lender requires a larger equity cushion to protect their investment.

The most complicated aspect is property cash flow and expenses, as this is where lenders have differing policies. Some lenders will use a rental offset which limits the amount of rent they recognize. Instead of including 100% of the rental income, they may only allow 80%

(and some only 50%) which can significantly impact the overall numbers. If there is a surplus it can be added to gross income. But in some cases it may leave a shortfall when deducting the mortgage and property taxes, as well as factoring in the payments for any other debts the borrower may have. This is where it becomes critical to have additional income to make up for it. Other lenders use a debt service coverage calculation to capture cash flow and expenses. They will recognize 100% of the rental income, but also need to factor in additional expenses such as insurance, vacancy, maintenance and utilities, in addition to the primary expenses of mortgage payments and property taxes. Usually this method is a more accurate way of obtaining a net rental income, but not all lenders offer it. They also require the property to meet a minimum debt coverage ratio. Even though the property may have cash flow sufficient to cover its expenses, if it doesn't meet the ratios, the lender may decline financing. In this case the only solution would be to lower the loan amount by increasing down payment.

While these are the main factors involved with financing an investment property, there are also several other points to keep in mind. A common situation I encounter occurs when a buyer is looking to purchase a property that they will occupy themselves along with a tenant. For example, the home may have a basement apartment they can rent out for additional income. However, unless the property is legally zoned as a duplex or has been legally converted to a multi-family property with proper retrofitting to meet building and zoning codes, lenders will not recognize any rental income from it. Nor will they recognize any rental income from individual rooms, or any other workspace such as a garage, shed or yard. This can make financing difficult if rental income is required to qualify for the mortgage. If a property or unit is not currently rented, an independent appraiser may be required to give a market rent evaluation of the property. Most lenders also have a limit on the number of properties a borrower can own in their name (which is usually between four and six). Once this number is surpassed, options become very limited in obtaining financing. Interest rates can also differ for rental properties as not all lenders will offer the same low rates for a rental as they would for an owner-occupied property and may add a premium to the rate. Refinancing a rental property can be tricky depending on what documentation is required to verify the income it generates. Some lenders only require lease agreements while others will base rental income from what was declared in taxes over the past two years.

Owning a rental property takes proper planning, up-front investment, finding the right tenant and a long term commitment to managing the property. Remember the four main areas a lender will review for mortgage financing – credit, income, down payment and property cash flow vs. expenses. Search out other real estate investors to get their advice and ideas on how they manage their property. Speak with a knowledgeable mortgage professional who has experience with financing these kinds of properties. When executed correctly, a rental property can be a valuable part of your investment portfolio.

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