Center for American Progress

Lease Purchase Failed Before—Can It Work Now?

By Sarah Edelman, Michela Zonta, and Julia Gordon April 29, 2015

In the wake of the Great Recession, America's homeownership rate stands at its lowest point in two decades.[1] Even as housing in some areas has become more affordable than ever, many aspiring homeowners have not been able to secure a mortgage in order to take advantage of this affordability because access to mortgage credit is so limited. Mortgage availability is tight not just compared to the housing-bubble years, but also according to broader historic standards.[2] Yet studies show that many renters still aspire to become homeowners.[3]

With potential homebuyers on the sidelines, both large and small investors have been buying enormous numbers of properties for cash. Cash buyers, who tend to be investors, comprised nearly 43 percent of all home sales in the first quarter of 2014.[4] Instead of flipping homes, as many investors have traditionally done after a housing bust, many of these investors have converted formerly owner-occupied homes into rental units. Between 2007 and 2011, more than 3 million single-family homes were converted into rental homes.[5] At least 150,000 of these homes have gone to larger companies that are establishing sizable rental portfolios on a multistate or even national basis.[6]

The confluence of these factors is fueling a new discussion about putting families on a path to purchase their rental homes. The lease-to-own approach could potentially benefit both landlords and tenants.

Transferring ownership to tenants theoretically provides an ideal exit strategy for investors, since it can save the investor the cost of marketing the property or selling it to another investor. It also provides a potentially valuable opportunity to renters, who could lock in today's low prices even though they cannot currently access mortgage credit. Furthermore, the lease-to-own approach could also help neighborhoods by minimizing the disturbance from vacancies and home maintenance that can occur when ownership changes hands.

However, these arrangements have a checkered past. Some programs have mainly harvested fees and deposits from renters, while other well-intentioned programs have run into other headwinds without delivering much conversion to homeownership. One aspect of the challenge is simple economics: It is not clear that programs with appropriate consumer protection are able to generate the level of return that many investors seek.

This issue brief explains the lease-to-own model, market, and risks and benefits; reviews lessons learned from previous programs; and offers a set of basic standards that lease-to-own programs should meet in order to protect consumers, neighborhoods, and the real estate market.

Background on lease to own

Lease to own is a term used to describe a variety of similar but not identical legal arrangements wherein a household does not purchase a property outright with a mortgage but instead pays some form of upfront fee and monthly payment for the option to purchase the house at the end of a specified term. These arrangements vary based on the state, and the forms of these agreements have also changed over time.

The type of arrangement garnering the most attention at present—and the one on which this paper will primarily focus—is the *lease-with-a-purchase option*, abbreviated for the remainder of this paper as *lease option*. Under this arrangement, a renter generally pays some form of upfront deposit or fee plus a rent premium and, in return, obtains the option to purchase the property, generally for a price that is locked in upfront. In some arrangements, the renter may assume an existing mortgage; in others, the renter obtains a new mortgage at the time of purchase. During the option period, the owner may not offer the property for sale to anyone else. Under this type of agreement, the owner is usually responsible for maintenance during this lease period, but some contracts require renters to cover maintenance costs. When the purchase option expires, the renter must either exercise or forfeit the purchase option. The initial deposit and the rent premium are generally applied to the purchase price if the renter exercises the option to purchase, and under some contracts, the renter forfeits both if the purchase does not take place.

Another arrangement that often gets included in the category of lease to own is a *contract for deed*, which is also known as a *land installment contract***.** This type of contract is a sale of property rather than a lease, but the payment of all or a portion of the purchase price takes place in installments over the period of the contract, often with a large balloon payment at the end of the term. In this type of contract, the seller holds the legal title to the property as security until the full payment is made.[7] If the purchaser is not able to pay the entirety of the contract, some contracts require the buyer to forfeit all the monies paid up to that time, although these forfeiture clauses have been challenged in court and weakened by some state legislatures.[8] Contracts for deed have a particularly dire history in communities of color, where they caused significant damage to families and communities.[9] While there is also new attention to the potential for using contracts for deed in today's environment, this paper focuses mainly on true lease-to-own agreements.

Despite predatory history, land contracts still prevalent in some communities

Land installment contracts have a fairly negative track record in terms of consumer protections. In the 1950s, sellers peddling land installment contracts who collected a down payment and monthly payments on a home with no intention of ever transferring ownership to the buyer caused serious harm to African American communities.[10] In the 1990s, predatory land installment agreements were commonplace in East St. Louis, Illinois. One owner, for example, hid tax, insurance, and interest fees from consumers and instead added these costs to the principal balance of the loan each month. As a result, the loan balance grew, making the home far more expensive than the consumer originally expected. For instance, one consumer entered into a land installment contract agreeing to pay less than $20,000 for a home, but years later when the contract was finally fulfilled, it would have cost the consumer $100,000.[11]

Installment land contracts are still common in the United States, especially among low-income purchasers who lack access to conventional mortgage financing.[12] While land installment contracts have been on the decline, households with these types of arrangements represent 5 percent of all homeowners in the nation on average.[13] These contracts are frequently used in Illinois, Texas, West Virginia, South Dakota, Ohio, South Carolina, and Florida.[14]

The number of land contracts held by Hispanic homeowners has increased over time, from about 400,000 in 2001 to more than 500,000 in 2009.[15] Seventeen percent of Hispanic homeowners with one mortgage hold a land contract compared to 10 percent of non-Hispanic white homeowners.[16] In a 2012 study of one Texas county, researchers found that less than 20 percent of the consumers who entered into contract-for-deed agreements—a type of land installment contract—ever converted to homeownership. Instead, 45 percent of the agreements were cancelled, which typically meant that consumers lost their entire down payment and all other monies paid on the home during the contract period.[17] Thirty-seven percent of the agreements were still in place at the time of the study's publication—they had neither been terminated nor had the consumer taken possession of the deed to the home.[18]

Today's lease-to-own market

Not surprisingly, families aspiring to homeownership who have found themselves unable to access the mortgage market because of poor or no credit, lack of down payment resources, or discriminatory lending practices have long turned to alternative products such as lease-to-own agreements or land installment contracts.[19] Much of what is known about these families and their experiences comes from court cases. For example, Florida-based businessman Rod Khleif owned hundreds of properties and advertised rent-to-own deals in at least seven Florida counties during the housing boom.[20] According to consumers, Khleif refused to sell them houses after they had paid thousands of dollars under rent-to-own contracts.[21]

In terms of the market now, calculations based on the Survey of Consumer Finances indicate that in 2013, about 1.6 million households that reported having had credit problems in the prior five years and were renting their homes claimed to be saving for a future home purchase.[22] These arrangements may also appeal to other groups, such as those who simply want to get into a desired neighborhood more quickly—for example, parents who want to be in a good school district for their kids—or those who are moving for their job and want to try out a new neighborhood before committing.[23] Lease-purchase agreements also might be useful for self-employed individuals who have trouble qualifying for a mortgage.

According to a CNN report,[26] there was enough of a spike in interest in lease purchase early in the foreclosure crisis that some websites for online home shopping, such as ForSaleByOwner.com, added rent to own as a search option. A quick web search reveals numerous offers of lease-to-own programs.[27]

However, it is almost impossible to find reliable aggregate data about the use of lease-to-own agreements. The American Housing Survey lumps these arrangements with typical mortgages, whereas it provides more detail for land contracts. There is no information collected through Home Mortgage Disclosure Act, or HMDA, data, and many lease-to-own arrangements are between a private seller and a private buyer, a situation in which neither party has any kind of reporting requirements.

What's more, other data sources suggest there may be fewer of these arrangements than meets the eye. For example, a 2013 CNBC article indicated that of the 609,482 sales transactions on record in San Diego, California, from 1990 to the present that were conducted with a real estate agent, only 782 were completed with a lease-option contract, according to the San Diego Association of Realtors.[28] Other potential sources of information such as mortgage giants Freddie Mac and Fannie Mae—which ran lease-purchase programs in the secondary market at one time—likewise have not published any data.

Finally, while there are plenty of examples of lease-purchase programs that have not served consumers well, there may be newer approaches that deserve attention. For instance, Home Partners and the Neighborhood Community Stabilization Trust are experimenting with new programs that, with the right protections in place, may offer new opportunities to consumers. (see "Home Partners' unique lease-with-option-to-purchase model" text box)

Home Partners' unique lease-with-option-to-purchase model

Home Partners, a single-family rental company backed by money management firm BlackRock and private equity firm KKR, is preparing to expand an interesting model that it has piloted in recent years. Home Partners targets households that cannot currently qualify for a mortgage but may be likely to qualify in a few years after repairing their credit.[24]

Under this model, the prospective homeowner client chooses a home from the public inventory of homes for sale—the local multiple listing service, or MLS—rather than from an existing portfolio of homes. Home Partners then buys that home and leases it to the client, who generally has up to five years to purchase the home.

The consumer does not pay an upfront fee for the option to purchase the property. However, the purchase price agreed upon at the time the lease is signed increases up to 5 percent each year. While the household is renting, Home Partners manages the property, according to the company. Home Partners, which began its work in Chicago, Illinois, has currently deployed about $500 million in 30 metro areas and will soon expand across the country.[25]

Benefits and risks of lease-option agreements

As noted above, lease-option agreements could potentially provide households with a valuable opportunity when they are not yet ready to buy but would like to eventually and want to move sooner rather than later. Benefits of lease option include the following:

- Renters can move into a home right away and begin to attend schools or otherwise set down roots in a neighborhood.
- Renters can access neighborhoods with fewer traditional rental opportunities.
- Renters get longer-term stability than a typical one-year rental lease, and the home cannot be sold out from under them.

- Under some arrangements, the renter can lock in a home price and maybe even a mortgage rate.
- Some lease-to-own program operators may use the rent premium to finance credit counseling or other supports to help the household become ready for homeownership.

However, if the agreement is not well designed or does not include sufficient consumer protections, lease option can be quite predatory and costly. Although these agreements vary significantly, there are some common risks that can emerge for consumers:

- **Lack of independent inspection or appraisal at the outset:** Some lease-with-an-option-to-purchase agreements do not provide households with the ability to conduct an independent inspection or appraisal to verify that the home is sound and the purchase price established by the option is fair. Without such verification, a consumer may be paying a fee and/or rent premium for a home that is not worth the agreed-upon price.

- **Maintenance costs borne by renter:** Some agreements require the consumer to cover some or all of the maintenance costs. However, shifting the costs of homeownership to households before they have purchased the home make it harder for them to save for eventual homeownership. Even when state law requires a landlord to make necessary repairs, many tenants in a lease-option agreement may believe they have this obligation and incur costs to repair a home that they never end up buying.[29]

- **No guarantee of conversion to homeownership:** Especially when the reason a household wishes to lease before purchasing is the inability to access mortgage credit at present, there is no guarantee that the household will qualify for a mortgage several years down the road. Additionally, if home values fall or fail to appreciate as predicted, the house may not appraise for the price agreed upon at the outset.

- **Losing money or locking into a bad deal:** Consumers who enter into a lease-to-own agreement may be less inclined to comparison shop at the outset, but it is possible that at the end of the leasing period, another home would be a better value, even accounting for savings on moving and some transaction costs. However, in many cases, the household would lose the upfront fee and may not get value for the rent premiums that have been paid.

- **Frauds and scams:** In some cases, the purveyors of lease-to-own agreements are engaging in outright fraud and have no intention of transferring the title under any circumstance.

At a December 2014 single-family rental industry conference, panelists described how lease-purchase agreements could make money for the company for reasons that had little to do with successful conversion to homeownership.[30] The panelists noted that these agreements help companies keep maintenance costs low because some require the renter-buyer to cover the costs of maintenance. One company—which offers a longer-term, 30-year lease with a purchase option—described shifting insurance and tax costs to tenants.[31] One panelist noted how rare it was for the renters to exercise the option to purchase the home, leaving the single-family rental company with the flexibility to continue renting the home or to sell it.[32]

Learning from nonprofit and government-supported programs

In recent decades, some mission-based nonprofits have developed lease-purchase-option programs, often by leveraging resources from various government programs. While there are a handful of well-known success stories on the nonprofit side, there are little hard data available that shed light on the scope and performance of many nonprofit lease-purchase programs. It is also difficult to determine whether the nonprofit approaches can be brought to scale in a responsible way, although the fact that it has not yet been done suggests the answer.

The Cleveland Housing Network, or CHN, a community development corporation, or CDC, operates the nation's longest-running lease-purchase program. CHN uses Low-Income Housing Tax Credits, or LIHTC, to attract equity investors who, in exchange for the 15-year tax credits, help CHN to buy single-family rental properties. CHN then offers these homes for rent at an affordable price of about $550 per month.[33] At the end of the 15-year period, the value of the home is usually between $30,000 and $80,000.[34] Renters who have successfully made it through the program are then able to purchase the home below the market value, usually for less than $20,000.[35] The organization is able to keep the home purchase price low because the LIHTC credits allow it to buy the home without going into significant debt. Moreover, the household, not the organization, keeps any home equity built during the time of the agreement.[36]

CHN also uses dollars designated for the city of Cleveland through the U.S. Department of Housing and Urban Development's, or HUD's, HOME program to offer lease-purchase participants an interest-free second mortgage, which only needs to be repaid upon resale or refinancing.[37] This model makes it possible for a household to lock into a long-term affordable rental home while also creating an affordable and sustainable homeownership opportunity. When the tenants convert to homeownership, they often have significant equity in the home. The rate of foreclosure among program participants is low. Out of 539 homes purchased through the program since 2010, only one homeowner has lost a home to foreclosure, according to CHN.[38] CHN reports that about 85 percent of participants are able to convert to homeownership through its lease-purchase program.[39]

The National Community Stabilization Trust prepares for new lease-purchase pilot

The National Community Stabilization Trust, a prominent nonprofit affordable housing intermediary, will soon launch Home Starter, a pilot program modeled after Freddie Mac's Lease Purchase Plus program, in communities where it is significantly more affordable to own a home than it is to rent one.[40] One of the potential benefits of this model is that prospective homebuyers can lock in today's fairly low interest rates by assuming the mortgage from the nonprofit instead of applying for a new mortgage later when rates may be significantly higher. Nonprofits will use the spread between the carrying costs of the home and the rental income to pay for quality credit counseling and to compensate the nonprofit for the risk associated with taking a mortgage on the home. The lease-purchase option will also be limited to 24 months and to households that the nonprofit determines have the financial resources to convert to homeownership by the end of that period.

In the early 2000s, Fannie Mae and Freddie Mac supported lease-purchase programs offered through nonprofits and local government entities that were designed to make it easier for the consumer to eventually obtain financing to purchase the home.[41] For example, Freddie Mac's Lease Purchase Plus program enabled a nonprofit organization to buy a home and enter into a lease-purchase-option agreement with a prospective homeowner, who under the terms of the program eventually assumes the mortgage after a period of renting.[42] The homebuyer keeps any home appreciation that occurs during the lease period.[43] There are not data publicly available about the outcomes of this program or other lease-purchase programs supported by Fannie Mae and Freddie Mac.

On the other hand, Self-Help, a high-performing community development financial institution, launched a lease-purchase pilot in Charlotte, North Carolina, early in the foreclosure crisis.[44] The program failed to generate as much demand as anticipated mainly because many of the households eligible for the program were able to obtain Federal Housing Administration, or FHA, financing to buy a home and, as a result, did not need to go the lease-purchase route.[45]

Challenges to creating a successful, consumer-friendly lease-purchase program

In a 2010 article, Bill Goldsmith and Cindy Holler, who led the New Cities Community Development Corporation lease-purchase program in Chicago during the 1990s, described the types of challenges the program initially encountered.[47] In short, the organization's lease-purchase program was trying to address too many challenges at once: housing stock that needed major rehabilitation, distressed neighborhoods, and applicants with poor credit who did not demonstrate the desire to own a home. New Cities did not have the funding nor the financing needed to address these challenges and the program nearly failed.

A combination of weak homes, weak markets, weak buyers, and weak rental property infrastructure lead to a failed program, Goldsmith and Holler said.[48]

Spotlight abroad

Helping U.K. renters save for homeownership

In September 2014, the United Kingdom launched a $600 million program designed to encourage the construction of new rental homes that the renters could later upgrade to home ownership. The program—Rent to Buy—is designed to provide renters with an opportunity to rent affordably now, save for a deposit, and then either buy the new home or a different home at a later date. This is how the program will work:[46]

- Housing associations—private nonprofit organizations that provide the bulk of low-cost rental housing in the United Kingdom—can bid for a share of available government funding in low-cost loans to build up to 10,000 new homes from 2015 to 2017.
- Single people earning up to $50,000 or couples earning up to $100,000 are eligible to participate in the program and will be offered fixed rents at 20 percent below market rates.
- Landlords must make the homes available for rent to first-time homebuyers meeting the eligibility criteria at 20 percent below market rates for a minimum of seven years, during which time tenants will have the opportunity to save for a deposit and prepare to purchase the home.
- At the end of the rental period, the tenant will have the right of first refusal to buy the property. Alternatively, tenants may choose to move out and buy a different property with the money they saved or rent another property either privately or with the housing association.
- The housing association has 16 years to repay the low-cost loan and must keep rents affordable until the loan is repaid. The housing association may use any profits from home sales to build more affordable homes.

In order to improve program performance, the organization diversified its portfolio of homes; worked with community organizations to recruit families, as Holler and Goldsmith put it, "from across the socio-economic spectrum" who wanted to be homeowners; made homebuyer education a mandatory component of the program; and secured more efficient financing. As a result, the program's homeownership conversion rates rose from 25 percent to more than 80 percent.[49]

Yet, the challenges that New Cities encountered as it developed its lease-purchase program underscore just how difficult it can be for an organization—even a dedicated, mission-oriented organization—to operate a financially viable program that is also consumer friendly. For instance, one of the ways that New Cities made the program financially viable was by shifting all property management responsibility, including responsibility for major systems repair, to the renters participating in the program. While this approach may have helped the organization save money on property management, this structure made the program much riskier for consumers. As described earlier in the brief, when consumers are required to cover the cost of maintenance before they own the home, they are taking on additional costs that make it harder for them to afford to eventually convert to homeownership.

Recommendations

Agreements designed to transfer ownership of a home to a renter should give consumers a reasonable opportunity to transition into safe, sustainable homeownership. A responsible agreement makes sure that a prospective homeowner is not weighed down by the costs of homeownership prematurely; keeps rent and fees reasonable; allows for an appraisal and inspection so the consumer knows exactly what they are purchasing; and, most importantly, makes conversion to homeownership a likely outcome for the consumer.

Here are eight recommendations for single-family rental companies or other landlords to follow as they experiment with lease-to-own products:

1. **Take steps to ensure, to the extent possible, that renters who enter into lease-purchase agreements will have the ability to repay a mortgage for the price of the home at the time of purchase:** Especially if the appreciation in home value is fixed—for example, as a certain price plus 3 percent per year—the initial screen of renters should take into account whether they can afford payments based on that future price of the home.

2. **Avoid rent premiums unless the renter receives immediate value and the premium is transparent:** Agreements that charge a higher rent to households that agree to a lease-purchase option often are not good deals for consumers unless that extra rent is refundable if the option is not exercised or unless the renter obtains something else of value, such as credit counseling or other types of supports. If a rent premium is charged, the premium should be fully transparent.

3. **Upfront payments should be reasonable and cover only basic acquisition costs:** An option fee should cover the company's cost of offering the option to the consumer. Inflated option fees or nonrefundable down payments increase the risk of financial loss to consumers if they are not able to exercise the option to purchase the home. A rental deposit may be required but should be refundable under the same circumstances as a security deposit for typical rental if the renter does not or cannot exercise the option.

4. **Include an upfront appraisal and inspection before the renter agrees to a lease-purchase option:** Before signing a lease-purchase contract for an agreed upon price, the renter should have access to a current appraisal and inspection in order to be sure that the purchase price is fair and that the house is in good shape. Renters should also know what type of down payment the lender would eventually require so they can prepare.

5. **Program materials should be clear and consistent about the terms of the lease-purchase agreement:** Marketing materials, informational brochures, and contracts should be clear and consistent so that consumers understand how the program works.

6. **Provide would-be homebuyers with HUD-approved housing counseling:** Providing independent, HUD-approved housing and credit counseling to consumers prior to entering into a lease-to-own agreement would help them better evaluate their options and prepare for sustainable homeownership. Offering financial readiness advice through a mortgage broker or other party with something to sell should be avoided.

7. **Renters should not prematurely assume the maintenance responsibilities of ownership:** Landlords should not use lease-purchase agreements as a way to avoid the cost of managing a rental home. Beyond changing light bulbs and taking care of the lawn, property maintenance is not the responsibility of a renter and assuming these costs while renting may simply put homeownership further out of reach. Landlords should maintain the property and provide tenants with basic rights so that as long as they make rent payments and respect the property, they are safe from eviction.

8. **Landlords should consider alternative ways to support prospective homeowners:** Because lease-purchase programs can be risky for consumers, it is recommended that landlords consider alternative strategies to help renters transition to homeownership.

   - *Report on-time rent payments to credit reporting agencies*: A strong credit score is needed in order to qualify for a mortgage: The median borrower with a conventional loan has a FICO score of 750, which far exceeds the average American FICO score of 699. The median score for a FHA borrower is 680, still well above the historical norm.[50] For households recovering from a foreclosure or loss of a job, the reporting of on-time rent payments may help them improve their credit scores more quickly. Some credit rating agencies now collect this type of information, but it is up to the landlord to report on-time payments.[51] Committing to reporting on-time payments could make it easier for households to repair their credit more quickly. A rental company should allow residents to choose whether they want their payments reported.

- *Offer longer-term leases*: Longer-term leases might be appealing to some renters hoping to set down roots and could help companies manage turnover costs.

- *Give tenants the right of first refusal*: Landlords can offer tenants the ability to buy their properties if and when the tenants become ready to buy and/or can provide tenants with a right of first refusal when the landlords are ready to sell. This type of policy provides a tenant with the opportunity to transition to homeownership and at the same time may be better for the surrounding neighborhood than the multiple changes of ownership that may occur when an investor sells a home.

Conclusion

Despite historically low home prices in many parts of the country, half of renters recently interviewed by Zillow, an online real estate database, are not buying a home because their credit is weak or because they lack the financial resources needed to buy and maintain a home.[52] For some of these households, which are near to recovering from the recession and foreclosure crisis, a well-designed lease-purchase product might help them lock into today's low home prices while they replenish their savings and restore their credit worthiness. However, given the thin track record of successful, consumer-friendly programs that are economically viable, it will be important to monitor new lease-purchase programs both to ensure that consumers are protected and to gather performance data so that high-performing models can be spotted that might offer a real bridge to sustainable homeownership.

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31 Ibid. As Eisinger reported: "Then Mr. Shaashua delivered the kicker to the roomful of would-be investment managers: 'Most times, given the reality, tenants do take it, but it's hard for them to execute the option,' he said. 'Our experience is that most stay until the end and then they say they cannot come up with the down payment or decide not to stay in the property.'"

32 Eisinger, "A Push for a Greater Government Role in Housing Finance."

33 Cleveland Housing Network, "LIHTC Lease Purchase Program Fact Sheet" (2014).

34 Ibid.

35 Ibid.

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