# Lease-to-Purchase: How to Build Homeownership

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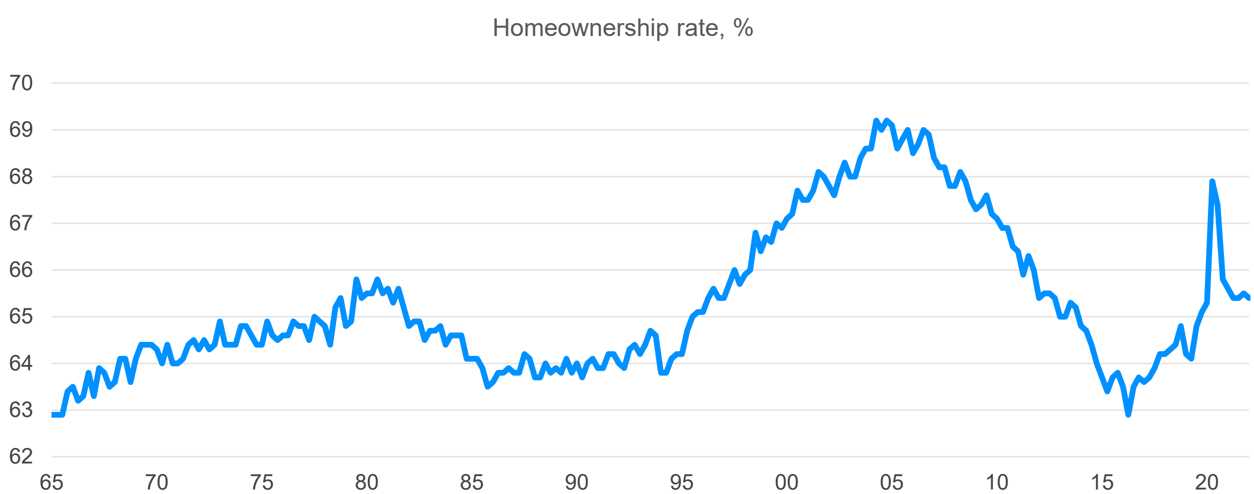
Policymakers have long sought to increase the nation's homeownership rate. Owning one's home is arguably the most effective way for lower- and middle-income Americans to build wealth and critical to building more stable communities and a stronger economy. Achieving this goal has been elusive, however. Homeownership is no higher today than it was two generations ago, and the prospects for increasing homeownership are daunting given higher mortgage rates, declining housing affordability, and broader demographic trends in which new household formation is likely to increasingly come from households with less generational wealth (see Chart 1).[1]

**Chart 1: Increasing Homeownership Has Proven a Daunting Challenge**




Sources: Census Bureau, Moody's Analytics

Given these challenging dynamics, policymakers would benefit from some new tools in their effort to expand homeownership. The nascent lease-to-purchase industry is poised to offer such a tool. Approximately 6% of U.S. adults have at one time used a lease-to-purchase arrangement to purchase their homes, but the number is set to increase. A growing number of private companies allow households to choose a home to rent with the intent of eventually purchasing it.[2] Participating households have the right, but not obligation, to purchase the home at a predetermined price when they are ready. This allows those who are almost ready for homeownership, but not quite there yet, to ease into homeownership at a pace and on terms that fit their family's financial situation. And it could be a particularly attractive feature during a time of rising interest rates and quickly rising rents and house prices.

With appropriate disclosures, household protections, and support from federal housing agencies, the lease-to-purchase industry has the potential to materially increase homeownership in underserved communities, particularly communities of color. According to Freddie Mac, at least 2 million Black Americans and 3.5 million Hispanic Americans are in their homebuying prime and "near-mortgage ready."

In this white paper, we begin with a general description of how lease-to-purchase works and a survey of the companies that operate in the industry. There are many variations on the theme, but the basic mechanics are straightforward. We then examine in detail the operations of two of the companies. Together, this provides a sense of the industry's geographic footprint, scale of operations, household-facing costs, and success in creating alternative paths to homeownership. We then offer a number of policy recommendations to help the industry scale to more meaningfully expand the equitable access to sustainable homeownership.

## How lease-to-purchase typically works

Lease-to-purchase arrangements, commonly referred to as "rent-to-own" or "lease with option to purchase," give households the ability to choose a home to rent until they are financially prepared to purchase it. The seller of the home is usually the landlord, and the household occupies the property as a tenant until it exercises the option to purchase the home, or its lease expires.

There are many variations of lease-to-purchase arrangements, but they generally involve the following features:[3]

- **Term.** The number of months the contract is in force.
- **Purchase price.** The price the household pays for the home when it closes at some future date.
- **Option fee.** An upfront payment that becomes part of the household's down payment if the option to purchase is exercised.
- **Rent credit**. Any additional above-market rent paid by the household to the seller, which becomes part of the household's down payment when the option is exercised.

Often in a lease-to-purchase arrangement, the household pays an upfront fee or down payment in exchange for the option to purchase the home within a designated period. If the household exercises that option, a portion of the household's previous monthly payments may be applied to the down payment for purchase, and either the seller or a financial institution extends credit to the household for the balance to be repaid over time. Typically, the deed transfers when the loan is originated. If the lease expires and the household does not purchase the home, the household moves out, as with a standard rental arrangement. If the home is sold subject to a rental or lease agreement, the terms carry over to the new buyer, including the option price and other provisions.

Done well, lease-to-purchase arrangements expand housing choices for aspiring homeowners and neighborhood options where there are few traditional rental properties. And they are a way for households to use their tenure as a tenant to improve their credit scores by making regular rent payments, build a credit history, and save for a down payment. In single-family housing markets increasingly fueled by investor-based cash purchases, lease-to-purchase arrangements help level the playing field by negotiating cash offers on behalf of households.

## Lease-to-purchase industry

While lease-to-purchase arrangements have existed for some time, the last decade has seen the emergence of a number of companies focused on this product. The most mature of these are Trio, established in 2001, and Home Partners of America, founded in 2012. Other notable firms in the industry that recently have been established include Divvy, Halo and Verbhouse in 2017; Dream America and ZeroDown in 2018; and Pathway Homes in 2022.

The geographic footprints of the lease-to-purchase companies vary significantly. ZeroDown and Verbhouse limit their activity to high-end homes in the San Francisco Bay Area, while Home Partners is active in 33 states and Trio is in 24 with plans for further expansion. Most other lease-to-purchase companies fall in between, such as Divvy, which operates in nine states, Halo in 15, and Dream America in three.

The lease-to-purchase arrangements offered by these companies differ considerably, but there are some basic similarities (see Box 1 for a description of some important differences). Households applying for a lease-to-purchase arrangement must meet certain eligibility requirements, including minimum income and credit score, maximum debt-to-income ratios including rent, and house price limits. Minimum income requirements generally range between $30,000 and $48,000 a year, and approved households must have a minimum credit score that ranges between 480 and 580. Applicants who just meet the minimum score threshold may also be required to meet additional liquid reserve requirements.

Households that meet the eligibility requirements receive a so-called rent budget to shop for a home they can afford to rent and ultimately purchase. Because single-family homes listed for sale have asking prices, but not asking rents, the lease-to-purchase company estimates rents for the homes in its footprint. How these rents are determined is not generally fully disclosed by the companies.

Lease-to-purchase companies also set a so-called buy box, which provides a lower- and upper-price limit on homes it is willing to buy on a household's behalf. Halo, or example, limits its customers to homes with asking prices between $150,000 and $600,000. Dream America's buy box goes from $150,000 to $400,000, and Divvy varies its buy box by market, ranging from $60,000 to $375,000 in St. Louis to $240,000 to $600,000 in Miami.

Most lease-to-purchase companies do not publicize significant information regarding the size of their portfolios or the number of households they have helped to become homeowners. Rather, they highlight selected accomplishments in their marketing and promotional materials. A few examples: Halo reports it "has helped hundreds of non-qualified mortgage applicants find a path to homeownership." And Divvy says that it has received more than 750,000 applications since 2017, that monthly homes closed have grown three times between their most recent and previous funding rounds, and that "households have exercised their option to purchase their homes at a rate of approximately 40 percent, estimated to be approximately ten times the conversion rate of major competitors."

To understand the industry more fully, we enlisted the cooperation of Home Partners of America and Trio, two firms with different business models and approaches. The companies—each of which is advised by one of this paper's co-authors—have shared with us previously unavailable operating and performance data. The companies are willing to disclose proprietary information to help policymakers better assess the industry to design policies that will encourage best practices and help scale lease-to-purchase into a meaningful, affordable homeownership strategy.

### Home Partners of America

Through Home Partners' lease-to-purchase product, households select a home listed for sale in a community that Home Partners purchases for cash on their behalf, and which households rent until they are ready to buy. Households' financial commitment under the program is limited to one year of rent plus a standard refundable security deposit, but a household also has the flexibility to renew its lease at a pre-established rental rate for additional years or to purchase the homes at a predetermined price if it wishes.

Households are required to have a minimum income of $40,000 and a minimum credit score of between 580 and 620 depending on the lease-to-purchase arrangement and the market.[4] The maximum rent-to-income ratio is consistent with Federal Housing Administration, Fannie Mae, and Freddie Mac financial ratio requirements that help ensure the affordability of the home.[5] Residents are also screened for disqualifying criminal history. Once approved, households are provided a rent amount based on an analysis of their income, credit history and debt levels that is consistent with the underwriting requirements the typical lender will apply when the household exercises its purchase option.

Approved households work with a licensed real estate agent to help identify a single-family home it can afford in a community it chooses. These communities typically have limited available rental housing, restricting housing choice for prospective residents who are not mortgage ready. To facilitate the home search, Home Partners provides its eligible home list price and the first-year rental rate, as well as predetermined rents for the next two to four years if the resident elects to renew their lease.[6]

After the resident selects a home that fits within Home Partners' buy box and the household's approved rent budget, Home Partners negotiates the purchase price with the seller, completes a licensed home inspection, and, if appropriate, buys the home for cash on the household's behalf and rents to it. The household has the right to buy the home at a predetermined price if and when it so chooses. The household is also provided a purchase price for each year of the lease term, which is finalized and included in the lease documentation once the purchase price and Home Partners' upfront capital expenditure for the home have been determined.

Annual fixed rent increases in the program are currently capped at 3.75%, well below current market rent increases that are in the double digits in most markets.[7] The right-to-purchase price, which currently increases at a fixed annual rate of 3% to 5.5% depending on the market, is also well below current house price growth in most places.

Households that are in good standing have the right to extend their leases at each lease anniversary for up to three to five years depending on the market. This provides the residents with transparency around future costs while they prepare for homeownership. If a household chooses to purchase the home, it can benefit from any house price appreciation above the preset pricing. Because residents are free to move out at the end of their lease term without cost or penalty, they also have no exposure to house price declines, since they can decide not to purchase if the value of the home has declined. The right-to-purchase option does not include any additional fees; there are no financial penalties, and there are no nonrefundable deposits or home remarketing fees for residents who choose not to purchase the home. During the lease period, repairs and maintenance in the home are provided and paid for by Home Partners, as would be typical in any single-family rental housing lease.

Home Partners' median house price when acquired was approximately $390,000 for homes purchased this year through mid-May, with an initial median rent of $2,370. The median credit score of all lease purchase residents is approximately 640 at move-in, with a mean household income of approximately $131,000.[8] The mean rent-to-income ratio is 22%, which is well below the 31% FHA front-end debt-to-income ratio, which measures housing costs as a percentage of gross income. The mean back-end DTI, measuring housing costs together with other personal debt obligations, is 36%, well below the FHA, Fannie Mae and Freddie Mac maximum of 50%.

From inception through May 15, 2022, Home Partners has helped approximately 30,000 households in 33 states. Homeownership success rates through Home Partners' program have risen to 43% in 2022 for all households independent of when they moved in (see Box 2).[9] The median time between when a household enters into a lease and exercises its option to purchase the home is 1.9 years. Exercise rates have been supported by the low-interest rate environment and high levels of house price appreciation; therefore, the homeownership success rate may decline as market conditions change. Given recent robust house price growth, it is likely that lease-to-purchase households that have been in their homes for at least 18 months enjoy house prices that far exceed the option prices.[10] An estimated 60% of those exercising their purchase options financed their homes with either FHA (47%) or VA (13%) mortgages, with almost all the others using conventional financing.

Earlier this year, Home Partners launched a new version of its lease-to-purchase product known as Choice Lease, which is targeted to low- and moderate-income households with incomes less than 80% of area median income.[11] The mean income of Choice Lease residents is approximately $62,000, about half that of the standard program. The initial Choice Lease median rent is approximately $1,950. The median purchase price of Choice Lease homes purchased was $295,000 and the median credit score of current Choice Lease residents is approximately 650.

Choice Lease operates similarly to Home Partners' standard lease-to-purchase program, but Choice Lease provides an approximately 10% discount to market rent for low- to moderate-income households, fixed annual rent increases that are capped at 3.75% per year for up to five years, and a 3.5% fixed annual purchase right escalator, compared with the current maximum 5.5% cap in the standard lease-to-purchase program. Choice Lease is made possible by dedicated long-term equity capital and the expectation that the below-market rents will drive stable occupancy and high tenant retention, resulting in an attractive risk-adjusted return.

## Trio

Trio's lease-to-purchase product, the OwnOption FHA mortgage, combines a fully assumable 30-year fixed-rate FHA mortgage originated at lease inception, with a three- to five-year lease-financing agreement. The assumable mortgage allows the household to lock in mortgage rates and get into the home and neighborhood of its choosing while working toward mortgage readiness. Trio uses the FHA's traditional 203(b) mortgage program, which allows a governmental instrumentality to qualify as the initial borrower and serve as the FHA's counterparty until the household is ready to assume the mortgage or otherwise purchase the home. Trio serves as an administrator, underwriting and servicing the lease, and providing credit counseling, payment protection, and other risk-reducing features.[12] These FHA loans are pooled and sold in standard Ginnie Mae securities.

Households are underwritten much like for a traditional FHA mortgage, though the terms are slightly more accommodating than for an entry-level FHA borrower. Trio considers a household's credit score and looks to the cash flow of the household to assist in underwriting, especially for households recovering from financial setbacks. To qualify, a household must have verified income and the ability to afford lease payments no greater than the equivalent of a 38% debt-to-income ratio. There is no minimum income requirement provided the household's debt-to-income ratio meets minimum requirements. Generally, they must have a minimum 580 score, though with some exceptions can go as low as 550; have no active bankruptcies, foreclosures or short sales; and have a verified on-time rental history for the last 24 months. Applicants are also screened for disqualifying criminal history.

Trio does not require a security deposit, minimum down payment, or other cash reserves from the household at lease inception. The initial financial commitment of the household includes an origination fee and program fee (similar to mortgage origination), and their first monthly payment. Customers that decide to move out for whatever reason without exercising their option to purchase the home also incur a $795 move-out fee to cover turnover costs. Households that have been under lease beyond the initial 24-month term may end the lease with 60 days' advance notice, and for those wishing to leave within the 24-month term, Trio will work with the household to find a new household to assume the lease.

The household's monthly lease payments are fixed at the FHA mortgage payment plus a margin to cover servicing and debt service. Thirty-six-month initial lease terms are provided, including two one-year extensions allowed at the option of the household with Trio's approval. There are no rent escalators, though lease payments are tied to the underlying mortgage payment increases and can adjust upward due to increased escrow to account for higher taxes, for instance. Trio charges a onetime underwriting fee of $1,295 and 1% origination fee, plus ongoing monthly servicing fees, similar to mortgage servicing.

After moving in, households typically have up to three years to qualify for a mortgage, during which time Trio's Department of Housing and Urban Development-approved counseling agency provides up to 24 months of counseling to assist. The household can exercise the purchase option at any time during the lease term to assume the original mortgage or, if rates have gone down, use a new mortgage to purchase the home when the household is ready. To prevent flipping and to manage prepayments, the household can only use outside financing after 24 months. Whether assuming the original FHA mortgage or using new, outside financing, a household must be able to qualify for a fully underwritten mortgage at the point it exercises its option.

The option price of the house is set based on the original purchase price negotiated by the household plus capitalized closing costs. Households with incomes below 80% of area median income are offered option prices set at the original purchase price plus a flat 1% of the original purchase price. For other households, option prices are set at the original purchase price plus 1% per year. A down payment savings credit is earned for each on-time monthly lease payment, accumulating to 3% to 5% of the purchase during the first 24 months. This down payment plus any of the house price appreciation above the purchase option price is available to the homeowner to offset loan costs or as additional down payment.

Since first-time homebuyers often do not have adequate savings should they face a financial challenge, Trio's product includes hardship insurance to help households get back on their feet after an unexpected life event such as temporary job loss, reduction in income, a onetime medical expense or car repair, a death, disability, or a natural disaster. Contractual coverage begins when the household enters into an agreement with Trio. Premiums, which start at 15 basis points of the house price per year, are collected with 12-month terms for rentals and 36 months for mortgages. Should a hardship occur, a claim is assessed by a HUD-approved counseling agency. If approved, one-half of the monthly payment is waived for the household with the insured mortgage servicer receiving reimbursement. In the case of a default, all of the payment is covered.

Trio's lease-to-purchase product differs from Home Partners of America's in several ways. Most obviously, Trio is able to offer households an assumable FHA mortgage. This is a particularly attractive feature during a time of rising interest rates and quickly rising rents and house prices. Trio households have similar credit profiles to those of Home Partner households, although the incomes and house price of the average Trio household are somewhat lower than those of a

Home Partners household. Both Trio and Home Partners allow a household to select a home listed for sale that it would like to purchase, often working with a local licensed real estate agent in the communities they serve. But unlike Home Partners, Trio does not buy the home on behalf of the household. Rather, traditional mortgage lenders originate the FHA 203(b) mortgage to a state, tribal or local government instrumentality that serves as the purchaser and mortgagor at lease inception.

Experience with Trio's lease-to-purchase product is too limited to generate statistically reliable homeownership success rates, but early experience looks promising (see Box 3). Trio reports that through April of this year, 470 FHA OwnOption Mortgages have been originated, totaling nearly $120 million in 12 states and concentrated mainly in Georgia, Texas, Arizona, California and Nevada. In total, 80 households have successfully exercised their purchase options and are now homeowners. Of these conversions, 75% have been to people of color, of whom approximately 85% are Black, 10% Latino, and 5% Asian-Pacific. These percentages are largely consistent with the racial distribution for Trio's overall OwnOption mortgage originations.

The average purchase price at lease inception is $254,100, with an average purchase option price when a household assumes the loan of $263,900. The average time to exercise across the program has been 36.6 months. For participants who assumed their mortgage, mean household income is $97,935 and 132% of HUD area median income. Households exercising their purchase option have enjoyed the benefit of quickly rising house prices, as the average appraised value at the time of the purchase was $20,460 more than the average purchase option price. For context, the typical Trio household owned assets of only $6,000 when it began its lease. To date, there have been no delinquencies and defaults on Trio's OwnOption FHA mortgages. By comparison, FHA mortgages to first-time homebuyers with down payment assistance typically have a 7% delinquency rate and 3% default rate.

## Guarding against potential abuses

Appropriate concerns have been raised that certain lease-to-purchase and similar arrangements could take advantage of aspiring homeowners who do not have the information or financial understanding they need to adequately assess whether such an arrangement makes sense for them. For example, in some circumstances with less reputable providers, households may have little recourse in securing title following the end of the lease term. Arrangements may impose punitive penalties if a household is unable or unwilling to purchase the home. Also, arrangements may impose high price escalators that deprive the household of valuable equity or even leave the household out in the cold if it is unable to secure a mortgage at the end of its lease term. Some arrangements hold out the promise to a path to homeownership but can result in low rates of conversion due to unfriendly product features. These include:

- **Option premium.** The household is often required to make a substantial down payment toward the purchase price of the home. If a household decides not to buy the home, under some contracts it may forfeit this initial deposit as well as any other investments it has made in the home, such as repairs or renovations.
- **Lack of legal recourse.** In most lease-to-purchase arrangements, if the household should default on rent payments, it would eventually face eviction, but in some circumstances, it may lack any legal option to fully recuperate its investment, such as through sale or foreclosure.
- **Home condition.** Some lease-to-purchase companies sell homes in a state of disrepair, or properties that have housing code violations such as elevated levels of lead or unpaid taxes and other fees. There even have been reports that some homes sold were condemned and slated for potential demolition, and that these conditions were not adequately disclosed to consumers.
- **Lack of independent inspection.** Some lease-to-purchase arrangements do not provide households with the ability to conduct an independent home inspection or appraisal to verify the home is in good condition and the purchase price is fair.
- **Binding sale agreement.** Some lease-to-purchase arrangements bind the household to buy the property at the end of the lease term.

## Policy recommendations

Given the rapid increase in demand for lease-to-purchase arrangements, the proliferation and variety of arrangements offered by the growing number of providers, and the need to protect households from abusive practices, policymakers should consider measures to expand access to responsible lease-to-purchase arrangements that make sustainable homeownership more inclusive and equitable for a larger part of the population.

To date, the federal government's support for lease-to-purchase arrangements has been limited to nonprofit or governmental sponsors. Policymakers should consider prudently expanding support to those lease-to-purchase arrangements that show the greatest promise for increasing homeownership for households that are close but not yet able to qualify for a traditional mortgage, and for narrowing wealth gaps. Policymakers should also guard sufficiently against potential abuses by requiring that arrangements meet standards for disclosure and ensuring households benefit if they exercise the right to purchase their home and are not materially worse off if they choose not to. We are hopeful that policymakers consider lease-to-purchase arrangements an important part of the all-of-government commitment to create a more equitable housing finance system to help reduce racial disparities in access to credit and homeownership.

## Disclosures and public reporting

As a general principle, lease-to-purchase companies should comply with the protections applicable to all renters and rental property owners. But given the complexity and costs associated with how some lease-to-purchase arrangements are structured, they should also adhere to strong disclosure standards regarding the terms of the arrangements and their success in supporting increased homeownership. They should specify:

» **Right-to-purchase options.** The financial aspects of the transition of households from renters to homeowners vary widely across lease-to-purchase arrangements. Some provide a cost-free option to purchase, while others charge fees of various amounts; some are nonrefundable if the option is not exercised; and some refund the option fee if the household elects to buy. As a condition for accessing expanded federal financing, policymakers should develop appropriate disclosure requirements that apply to the purchase option, including annual rent and house price escalators to ensure that households are fully aware of their obligations, including any financial consequences of not exercising their purchase option.

» **Rental rates vs. forced savings vehicles.** Many lease-to-purchase companies set market rental rates on for-sale single-family homes that lack rental histories using their respective proprietary algorithms. In addition to setting baseline rental rates, and periodic rent escalators that apply to each successive leasing period, some companies also require or incentivize renters to make additional monthly payments to help grow a down payment that is available when they exercise their right to purchase. While these funds would be routinely accounted for in the event of a successful household purchase, it is important that where they exist, their disposition and refundability be made clear for households that do not exercise their option.

» **Homeownership success rates.** Since the objective of lease-to-purchase is to provide households unable to obtain mainstream mortgage financing an alternative path to homeownership, lease-to-purchase companies accessing federal financing should be required to periodically report the number and rate at which their households transition to homeownership by buying the homes that they initially occupied as renters. Measuring this is not a straightforward exercise and requires thoughtful consideration by policymakers.

## Government-backed financing

To maximize the wealth-building potential benefits to households, government-backed financing should be specifically designed for lease-to-purchase arrangements. The FHA's single-family purchase mortgage already has an assumable feature, which should be streamlined and broadened to make it more widely available and effective in supporting increased homeownership. Similarly, the Federal Housing Finance Agency should set the terms for and encourage Fannie Mae and Freddie Mac, the government-sponsored enterprises, to pilot lease-to-purchase mortgage products with features favorable for lease-to-purchase as part of their affordable housing and equitable housing finance missions.

Both Fannie Mae and Freddie Mac have prior experience with lease-to-purchase for a brief time prior to the financial crisis. Fannie Mae offered a fully assumable OwnOption product in conjunction with Trio that allowed a nonprofit entity to serve as the mortgagor until the household was ready to assume the mortgage. Freddie Mac's Lease-to-Purchase Plus assumable mortgage was reserved exclusively for state and local housing finance agencies.[13] The assumable mortgages were held in trust by the originating housing finance agency. Upon assumption, the loans and securities they collateralized became fully liquid and sold to global investors in the forward to-be-announced market.

Government-backed financing should be available to lease-to-purchase companies whose products are structured in a manner consistent with the prudential, affordable housing and equitable finance policies of the FHA and GSEs. Moreover, for households that do not exercise their rights, companies that receive favorable financing should offer products that leave those households not materially worse off than similar renters in that market. The FHA and GSEs should require that any equity generated from house price gains accrued during the lease period determined by an appraisal that exceeds the option sales price accrues to the household's benefit by counting toward all or some designated portion of the required down payment at loan closing.

### FHA's role

While the FHA's authorizing statute limits the use of its single-family 203(b) assumable mortgage program, its assumable feature has been available to nonprofit sponsors and approved instrumentalities of government that can qualify as approved FHA mortgagors to administer a scalable lease-to-purchase program.[14] Save for Trio, no other lease-to-purchase company has navigated the intricacies required to advance its lease-to-purchase product. The process for approval of government housing agencies as mortgagors for the purpose of FHA insurance eligibility remains costly and cumbersome and varies across the country. This creates frictions and uncertainty that stymie the extension of these lease-to-purchase products to more American households that could benefit from them.

HUD should substantially simplify and streamline the process for approval of government housing agencies as mortgagors for the purpose of FHA insurance eligibility. It should also standardize its training of HUD Homeownership Center staff to broaden availability of the opportunities created by the product for aspiring homeowners that are near but not quite yet eligible for a traditional mortgage. This could also benefit the health of the FHA's insurance fund by delivering to the FHA at the point of assumption a household that has a proven payment history and is often less leveraged than the typical FHA first-time homebuyer.

But to enable lease-to-purchase companies to scale, we believe that HUD needs to do more. A former FHA commissioner-turnedacademic has provided a useful blueprint for how HUD can make the 203(b) program available to lease-to-purchase companies within existing statutes. This would be done through the Lease Equitably and Purchase, or LEAP, mortgage, which we support and would encourage HUD leadership to implement.

To be eligible to participate in LEAP, approved rental entities, both nonprofit and for-profit, would need to demonstrate their management capacity to own and manage single-family rental properties, and have the financial capacity to take on the debt, including risk-sharing by providing a guarantee during the lease period and meeting minimum capitalization requirements.

LEAP mortgages would be offered through approved select FHA servicers that would have to demonstrate experience with and knowledge of existing regulations governing FHA assumable mortgages and be committed to working with the full range of FHA-eligible borrowers, who require manual underwriting due to lower credit scores or higher debt-to-income ratios, or use alternative data like on-time rental payment history to qualify borrowers.[15]

LEAP mortgages could be originated only at the same time that the company has identified a prospective household and is executing the lease-to-purchase contract, so that the loan would be constructively held in the name of the homeowner-to-be, eliminating the potential for long-term investor holds of the rental properties.

To ensure that LEAP is not used on a continual basis to finance single-family rentals, if the household does not purchase the home and assume the loan within the defined program parameters, the company must either sell the home to a third party and repay the LEAP loan, have it assumed by another qualified borrower, or repay the LEAP loan and renew the lease to the existing or a new tenant with no lease-to-purchase option. Prospective LEAP borrowers would need to meet FHA lending criteria when the mortgage is assumed in one to five years, which would require future assumption underwriting.

### Fannie and Freddie's role

The GSEs' role in lease-to-purchase should be limited to helping them meet their affordable housing and equitable finance mandates. This could be done via:

- **Term financing.** The GSEs would provide term financing of up to five years at favorable rates to companies to acquire individual single-family homes on behalf of individual potential future homebuyers. The cheaper financing could be used to make rents more affordable during the leasing period. To qualify for such financing, companies would need to demonstrate that the full benefits of the advantageous funding terms would be utilized to provide reduced rents or otherwise fund a qualifying product meeting agency affordable housing and equity finance mandate requirements. To reduce taxpayer risk during the rental period, these loans could also require some form of limited private guarantee or cross-collateralization.
- **Assumable mortgage.** The GSEs would create an assumable feature to their respective affordable, low-down-payment mortgage products, including Home Possible and Home Ready, and incorporate rent seasoning into both their underwriting and pricing. Because these mortgages would not be TBA eligible during their rental phase, they may have to be held in the GSEs' respective retained portfolios until their conversion, unless an alternative approach can be devised. Even under existing portfolio limitations, a modest-sized lease-to-purchase pilot with appropriate protections could be accommodated without adverse impacts on safety and soundness. The FHFA should make this available to underserved lease-to-purchase households that consistently pay their rent on time, even with credit scores that are below the GSEs' current 620 cutoff.

Rent seasoning would come into play both in setting minimum borrower credit requirements and in GSE pricing. With respect to the former, there is a growing body of research suggesting that a clean rental history may mitigate credit risk for lower-credit-score households with thin credit files and be a good predictor of credit risk for some households that lack a credit score.[16] Last year, Fannie Mae modified its Desktop Underwriter system to consider 12 months of positive rental payment history derived from bank records for first-time homebuyers initially rejected under its automated model, and in July of this year, Freddie Mac did likewise. In short, extending the use of rental history in credit underwriting for lease-to-purchase households and making the loans assumable and lowering their cost could test the efficacy of lease-to-purchase to strengthen the GSEs' core missions.

### Conclusion

Policymakers face a daunting challenge in lifting homeownership in the face of rising affordability challenges and demographic trends. Without meaningful policy changes soon, homeownership is set to meaningfully decline in coming years. It is thus critical that policymakers give serious consideration to support promising alternative mortgage products and approaches.

Lease-to-purchase arrangements are one such option offering significant potential. They allow households that are not quite financially ready for homeownership to rent their future homes until and when they are ready to purchase. These households can include first-time buyers lacking an adequate down payment, recent college graduates with student loans, gig-economy workers or small-business owners who lack W-2 income, or those recovering from a financial or medical setback. These arrangements generally provide some certainty with future rent growth and the price of the home they plan to purchase and can help preserve affordability while households grow ready for sustainable homeownership.

An increasing number of private companies are working to establish lease-to-purchase arrangements that work and benefit households. But these efforts continue to face significant constraints. This is where policymakers can come in, by having the FHA, Fannie Mae and Freddie Mac provide the kind of favorable financing to support these programs consistent with their missions to support homeownership for lower- and middle-income households. In exchange for this support, these private companies must provide the information and transparency necessary to determine that underserved households are indeed successfully becoming homeowners.

With mortgage rates on the rise and housing affordability rapidly declining, it is increasingly prohibitive for American households to become homeowners. Prospects are that this will remain the case for a considerable time to come. There is thus no better time to elevate the policy conversation around lease-to-purchase.

## Box 1: Some Key Differences in Lease-to-Purchase Arrangements

**The lease-to-purchase arrangements and business models offered by the companies operating in the industry differ considerably in several respects. Complicating direct comparisons are differences in terminology and the availability of public information, but several features are worthy of attention.**

### Option fee

Significant differences in lease-to-purchase arrangements are evident in the costs associated when a household ends its lease and purchases a home. These range from no cost (Home Partners) to large, mandatory upfront charges that range from 3.5% to 5% of the house price, about equal to the down payment required on an FHA mortgage. These upfront charges may be fully or partially refundable if the renting household elects not to exercise its option to purchase the home.

In some cases, whether a company's business model features an option or mandatory purchase at the end of the lease period is a difference without distinction because large, unrecoverable upfront option fees could have the effect of coercing a household to exercise its option even when it has second thoughts and would rather let its lease expire without buying. The rationale for such charges is that they cover the company's costs selling the home when the household fails to exercise its right to purchase.

Dream America's option costs 5% of the house price and is nonrefundable unless the renter chooses to buy. In the company's words: "If you walk away from the house you will lose your option payment."[17] This is also true for Halo's 3.5% option cost. Similarly, if a Divvy renter chooses not to buy, the company "returns the extra cash the renter paid toward equity, minus a 'surrender fee' of 2 percent of the original purchase price," and also reserves the right to "assess a shared loss deduction to the tenant to help allocate some of the downside of home price depreciation."

ZeroDown charges a flat $10,000 fee for funding down payments on high-priced homes requiring jumbo loans and large down payments. Verbhouse's upfront option charge of 5% to 10% of the house price and a portion of each rent payment buys down the purchase price dollar for dollar, with the rent and purchase price locked in for up to five years. Verbhouse is the only company we found that allows its renters to cash out their option at fair market value by selling the home and allowing customers to keep market appreciation plus any equity accumulated during the leasing period through rent buy-down payments without exercising their purchase option.

### Rent credit

In some models, a household's required monthly payments may sometimes exceed the market rent set for the home the company acquires on the customer's behalf in order to provide a credit to help pay for a down payment at the end of the lease period. For example, Divvy requires its customers to make an additional monthly "home savings payment" on top of the home's fair market rent of 0.1% to 0.25% of the home's value ($200-$500 a month on a $200,000 home), making up approximately 10% to 25% of a resident's total monthly payments.

Pathway Homes, which launched its lease-to-purchase program this year, has a different approach to saving for a down payment for customers with some available liquid savings. Under its Savings Match option, tenants who invest 2.5% of the property's value up front will receive a dollar-for-dollar company match, resulting in total available cash at the end of the five-year lease term equal to 5% of the property's value.

### Maintenance during the lease period

Another potentially underappreciated aspect of lease-to-purchase agreements that households may overlook is the division of responsibility for home maintenance during the term of the lease. Again, practices vary and range from those approximating professionally managed rental complexes, where the property owner bears responsibility for all major building systems and appliance repairs and replacements (Home Partners[18]), to those where maintenance is the tenant's responsibility if not covered by the company-provided home warranty (Trio, Halo, Dream America). Divvy covers the costs of maintenance or repairs required to "ensure the home is safe and habitable."

### Rent increases

Rent increases are common to many lease-to-purchase arrangements and are generally designed to keep up with expectations for rising market rents, but some companies include aggressive rent increases in their contracts and others explicitly limit them. Home Partners, for instance, caps annual fixed rent increases at 3.75%, well below recent market trends, whereas Trio includes no rent escalators, as lease payments are tied to a 30-year fixed-rate mortgage originated at lease inception.

### Purchase price increases

Many lease-to-purchase arrangements also include house price escalators. These may be designed to keep up with expected house price appreciation but can run much higher or lower than actual or projected house price appreciation. They are thus a major consideration in the wealth-building potential of these products and can vary significantly by business model and market. Home Partners currently sets the house price increases at a fixed annual rate of 3% to 5.5%. Trio's right-to-purchase price generally increases at an annual rate of 1%, though households with incomes below 80% of area median income are offered prices set at the original purchase price plus a flat 1%.

# Box 2: Home Partners' Homeownership Success Rate

Home Partners defines its homeownership success rate as the percentage of residents who bought their homes in each period as a percent of all renters, including households that have decided to move out and those that have exercised the option to purchase the home. A household that leaves the program without exercising its option often moves to a different rental property or purchases a different home. Far less frequently it chooses to leave and continue to rent its existing home after the purchase option period expires. A significant number of lease-to-purchase households remain under lease with a continuing purchase option, and these households are excluded from the success rate calculation since the outcome for these households is not yet determined.

Home Partners' homeownership success rate has risen steadily, more than doubling for loans originated prior to 2018 and loans originated in 2021 (see Table 1). Approximately 38% of the households that signed up for Home Partners' product and left the program between the start of 2020 and end of 2021 exercised their right to purchase the home and become homeowners (see Table 1). The 2022 origination cohort was excluded given the small number of residents entering and exiting the program in the same year. Year to date through May, 43% of all residents who left the program, independent of origination vintage, purchased their home. Choice Lease has not been in place long enough to determine its homeownership success rate.Home Partners' homeownership success rate increases with the entry-level credit score of households (see Table 2). Perhaps unsurprisingly, success rates are higher for households that start with at least a 620 credit score for all vintages but are proportionately greater for more recent cohorts. Whereas 23% more households in the 2018-2021 cohort with entry-level scores above 620 exercised their purchase option relative to those below 620, this was true for 41% more households that signed their initial lease in 2021.

Behind the improving homeownership success rate may be a range of factors, including refinements in resident sourcing, credit criteria and market selection. Market conditions in recent years have also been helpful, as market house prices and rents have risen much faster than the fixed annual rent and purchase price escalation rates in Home Partners' lease-to-purchase product. This is shown for an actual home in Atlanta in Table 3.

The household benefits in the lease-to-purchase arrangement from rental rate increases that are capped below actual market rate increases, and house price growth above its right-to-purchase price. In the current market, the resident benefits in the form of significantly below-market rents, with a monthly saving of $520, and below-market purchase options worth more than $107,000. Moreover, in the event house price appreciation is low, the household has the option to leave without penalty at each lease anniversary date, and if house prices decline, the household is not exposed to downside risk as an owner during the rental period. If a household has an adverse change in financial condition, its financial obligation is limited to one year of rent.

### Table 1: Home Partners' Homeownership Success Rate by Year of Acquisition, Through 2021

| Origination yr | Success rate, % | Resident purchases | Resident purchases plus residents who left the program and did not buy |
|---|---|---|---|
| Prior to 2018 | 16 | 1,253 | 8,005 |
| 2018-2021 | 23 | 1,441 | 6,336 |
| 2019-2021 | 30 | 974 | 3,271 |
| 2020-2021 | 38 | 513 | 1,356 |
| 2021 | 38 | 184 | 487 |

*Sources: Home Partners of America, Moody's Analytics*

### Table 2: Homeownership Success Rate by Applicant Entry Credit Score, Through May 15, 2022

Success rate by credit score, %

| | <=620 | >620, <=680 | >680 |
|---|---|---|---|
| Prior to 2018 | 13.5 | 17.5 | 19.7 |
| 2018-2021 | 19.3 | 26.4 | 24.1 |
| 2019-2021 | 25.3 | 33.2 | 32.3 |
| 2020-2021 | 32.4 | 41.2 | 38.8 |
| 2021 | 26.4 | 40.4 | 41.7 |

Note: Credit score is the avg credit score of all household members who will contribute to rent, weighted by the amount each household member's income makes up of the total income of the household.

*Sources: Home Partners of America, Moody's Analytics*

## Table 3: Financial Benefits of Lease-to-Purchase

| | |
|---|---|
| Acquisition date | 1/9/20 |
| Current resident lease yr | 3 |
| Current right-to-purchase rent | $2,330 |
| Estimated market rent, rounded down | $2,850 |
| Current right-to-purchase price | $392,782 |
| Estimated market house price, Zillow estimate, rounded down | $500,000 |

Note: Example home selected from Home Partners portfolio June 15, 2022. Rental estimates and home value are based on a John Burns housing indexed rents and Zillow Z-estimates for the sample property as of June 15, 2022. The indexed rent estimate is consistent with Home Partners' internal estimates for the home.

*Sources: Home Partners of America, Moody's Analytics*

## Box 3: Trio's FHA OwnOption Mortgage Success Rate

Trio's FHA OwnOption mortgage product can best be understood as having ramped up in four phases corresponding with HUD's review and authorization of participating government agency mortgagors. Phase One initiated and completed the first FHA OwnOption mortgage originations and sale of the related Ginnie Mae mortgage securities in 2016. In 2017 and 2018, Phase Two expanded to Georgia with a number of participating lenders and homebuilders. Phase Three began in 2019 and included program expansion to Texas, Arizona, Nevada, Colorado and Tennessee. Beginning in 2022, Phase Four originations are now national in scope under two master servicers with correspondent lender channels. The table below describes experience with the product to date.

The Trio OwnOption FHA mortgage has resulted in 80 households that entered a lease at mortgage inception and successfully completed the transition to homeownership. Twenty-six households, meanwhile, exited the program without purchasing. This yields a lifetime homeownership success rate under our methodology of 75%. We can also look at originations from 2016-2018 or Phases One and Two, which have now experienced a full cycle of the first term of the corresponding three-year Trio contracts. Of the 183 loans that were originated in California and Georgia in this combined three-year period, 75 households purchased and 21 exited without purchasing, for a homeowner success rate of 78%. The most recent origination vintages have yet to convert but have also seen few exits, which may indicate features of the Trio model encourage households to delay exercising their purchase options.

### Table 4: Trio's Homeownership Success Rate by Year of Acquisition, Through 2021

| Origination yr | Success rate, % | Resident purchases | Resident purchases plus residents who left the program and did not buy |
|---|---|---|---|
| Prior to 2018 | 78 | 45 | 58 |
| 2018-2021 | 73 | 35 | 48 |
| 2019-2021 | 50 | 5 | 10 |
| 2020-2021 | n/a | 0 | 3 |
| 2021 | n/a | 0 | 0 |

*Sources: Trio, Moody's Analytics*

## Endnotes

1 The poor prospects for homeownership under current housing and mortgage-related policies are clearly presented in a recent study by the Urban Institute Center for Housing Finances.

2 This is based on a recent survey by Pew.

3 A good description of lease-purchase arrangements is provided by the Mortgage Reports. There are legal distinctions between a lease with an option-to-purchase agreement and a lease-to-purchase agreement. The former obligates the seller to sell during the leasing period at the option of the renter, who is not obligated to purchase the home. A lease-to-purchase agreement commits both parties to the sale, “barring breach of contract or the buyer’s inability to secure a mortgage.” The companies we reviewed generally do not formally identify which of the two types of rent-to-own agreements they utilize.

4 According to the Federal Reserve Bank of New York, the median credit score of newly originated mortgages in the U.S. in the second quarter of 2021 was 786. https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/hhdc_2021q2.pdf

5 The max front-end DTI (inclusive of housing-related expenses) is 31% for the FHA and the maximum back-end DTI (inclusive of all personal debt obligations) is 50% for the FHA, Fannie Mae and Freddie Mac.

6 Home Partners provides live rental rates on partner brokerage websites, including Coldwell Banker, Berkshire Hathaway HomeServices, Century 21, and other select brokerage firms.

7 Double-digit year-over-year rent growth through June 2022 is evident in nearly all markets across the country.

8 Credit score is the average credit score of all household members who will contribute to rent, weighted by the amount each household member's income makes up of the total income of the household.

9 The numerator is the number of residents within a given acquisition (move-in) year who purchased their home, and the denominator is the number of all residents who exited the program (number who purchased + number who left the program without buying).

10 Trailing 12-month home values are based on a Zillow indexed value. Population includes homes owned for at least 18 months as of March 31, 2022.

11 Choice Lease was originally launched on a pilot basis in three test markets in 2019. Following Home Partners’ acquisition by Blackstone in July 2021 as well as the moderation of the impact of the COVID-19 pandemic, Choice Lease was formally relaunched in January 2022, at which time it was expanded to 17 markets. Blackstone and Home Partners have committed to acquire at least $1 billion in homes through the Choice Lease program over the next two years, with the goal of enabling 3,000-4,000 low- and moderate-income households to become homeowners.

12 The Trio program includes a number of features designed to help households achieve sustainable homeownership while also protecting the FHA’s Mutual Mortgage Insurance Fund and taxpayers by extension. These include:

Requirements for pre- and post-closing housing counseling (paid for by Trio);

Cash reserves (posted by Trio);

Mortgage Protection Policy (an insurance product Trio adds to provide gap coverage to FHA and Ginnie Mae investors, paid for at closing, that adds 128% payment default coverage);

Healthy home inspections (every six months);

Home warranty throughout the lease term;

Hazard policy; and

Renters policy.

13 This information was obtained from firsthand interviews of individuals who participated in this program.

14 See 12 U.S.C.A. § 1709(g).

15 This is added by this white paper’s authors.

16 For example, Goodman and Zhu (2021) used past mortgage payments as a proxy for rental payments, estimating that they predict future mortgage performance even better than credit scores.

17 Elsewhere on its website, Dream America says if after renting for 12 months the renter decides not to buy the home, they can ask Dream America to sell it. The company says that if it is able to recoup its costs, earnest money will be returned to the renter after the house is sold.

18 The purchase price in the right-to-purchase agreement, as set at the time the customer enters into the lease, includes an adjustment equal to $2,500 for what Home Partners calls a "Maintenance Adjustment." If the customer chooses to purchase the home, and the maintenance costs covered by the Maintenance Adjustment actually incurred by Home Partners during the lease are less than the Maintenance Adjustment, the purchase price of the home at closing will be reduced by the unused amount of the Maintenance Adjustment.

## About the Authors

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Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by The New York Times as the "clearest guide" to the financial crisis.

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