Expanding Access to Homeownership through Lease-Purchase

A Report Commissioned by:

J. RONALD TERWILLIGER FOUNDATION for HOUSING AMERICA'S FAMILIES

Authored by:

Carol Galante
FACULTY DIRECTOR

Carolina Reid
FACULTY RESEARCH ADVISOR

Rocio Sanchez-Moyano
GRADUATE STUDENT RESEARCHER

TERNER CENTER FOR HOUSING INNOVATION
UC BERKELEY

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Introduction

The federal government has long promoted homeownership through preferential tax treatment, credit enhancements offered through the Federal Housing Administration (FHA) and the government-sponsored enterprises (GSEs), regulations and enforcement of fair lending laws, and the power of the bully pulpit.[1] However, the foreclosure crisis and subsequent recession have made it increasingly difficult for households to buy a home. In 2016, the U.S. homeownership rate dropped below 63 percent, its lowest level since 1965. Access to credit has become increasingly limited, especially for first-time homebuyers. Combined with the impact of rents and housing prices rising faster than incomes, an inadequate inventory of affordable homes, high levels of student loan debt, and demographic shifts, young families are increasingly locked out of the homeownership market.

While no one wants to return to the overly loose lending practices prevalent during the subprime boom, limiting access to homeownership will only serve to weaken the U.S. economy and widen the wealth gap. Alternative models are especially needed to ensure that lower-income households have access to sustainable homeownership. One such model, the lease-purchase mortgage, allows a household to rent a home for a period of time before taking on the mortgage and ownership of the property. This rental period allows households to build a positive credit history and increase their savings before taking on the responsibility of a mortgage, while at the same time “locking in” lower interest rates and house prices. Lease-purchase programs can also contribute to neighborhood stabilization, bringing the stability and investment associated with homeownership to communities still suffering the lingering impacts of the foreclosure crisis.

Particularly in the wake of the financial crisis, the benefits of this type of alternative model have led to a resurgence of interest in lease-purchase, and both public and private sector actors have been exploring the viability of lease-purchase products to responsibly and sustainably help families enter homeownership. To date, however, these efforts have been relatively limited in scale: the investment capital needed to purchase the properties is expensive, jeopardizing the goal of keeping them affordable for first-time homebuyers in the lease-purchase arrangement. There are also regulatory and consumer protection concerns. Lease-purchase agreements, and their cousins, land contracts,[2] can be predatory in nature, with terms that make it difficult for a borrower to successfully transition to homeownership.[3]

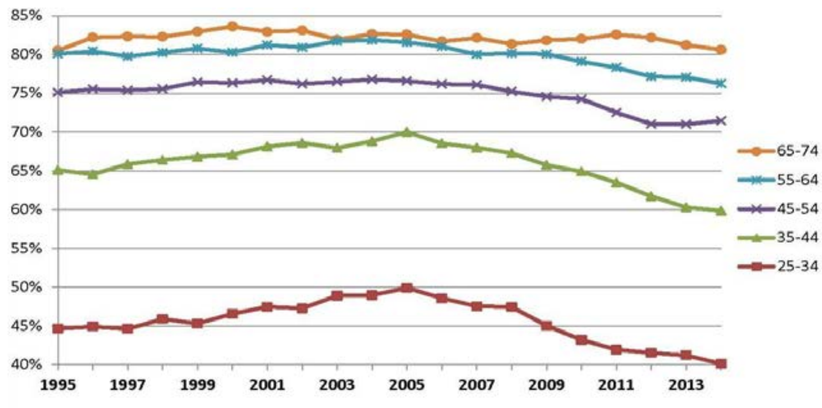
In this brief, we propose that the federal government support the expansion of lease-purchase models for homeownership with the Lease Equitably and Purchase (LEAP) mortgage, a pilot program run through the Federal Housing Administration. The LEAP mortgage would be an assumable, fixed rate, high loan-to-value mortgage product that would be available to nonprofits and other entities as part of a lease-purchase program. The federal guarantee would reduce the costs of capital for organizations interested in expanding their lease-purchase programs, and FHA stewardship would provide an important layer of regulatory oversight and consumer protection. FHA already has some of the infrastructure in place to run such a pilot program: FHA mortgages are assumable—meaning that the mortgage can be transferred from an owner to the new purchaser—and nonprofits and government entities have already used FHA loans to facilitate lease-purchase programs (although only at a small scale). Although FHA's authorizing statute[4] constrains the ability of private investors to use FHA mortgages for rental properties, a well-designed lease-purchase program that limits the ability of a private entity to hold a rental property over the long-term and that is structured to ensure the transition to eligible homeowners could meet FHA's existing statutory requirements.

While a lease-purchase product would require careful program design, implementation, and monitoring to protect both FHA and the homebuyer, we believe such a product would be a major contribution to creating a path to homeownership for many families currently locked out of the market. In this brief, we begin by laying out the reasons why lease-purchase is needed, and describe the experiences and results of existing nonprofit and private sector lease-purchase programs. Based on the lessons learned from these programs, we synthesize and articulate the major barriers to bringing lease-purchase models to scale and present the LEAP mortgage as a potential way of addressing those barriers. We explore key features we believe should be part of a LEAP mortgage product to ensure that it benefits consumers and does not pose an undue risk to investors or FHA, providing the beginnings of a roadmap for implementation of a pilot.

Locked Out of Homeownership: the Need for Lease-Purchase

It is hard to overstate the impact of the recent financial crisis on the housing market and the accessibility of homeownership. In 2016, the U.S. homeownership rate dropped below 63 percent, recording its lowest level since 1965.[5] The decline has been particularly sharp among younger and minority households (Figure 1). Researchers at the University of Pennsylvania estimate that the national homeownership rate could fall even further in the coming decades—down to as low as 50 percent—if demographic trends, credit conditions, and housing prices relative to incomes continue on their current trajectory.[6] This would represent a seismic shift from the post-World War II norm, and would have significant negative implications for both intergenerational wealth building and for the U.S. economy.[7]

FIGURE 1: DECLINES IN THE HOMEOWNERSHIP RATE BY AGE GROUP



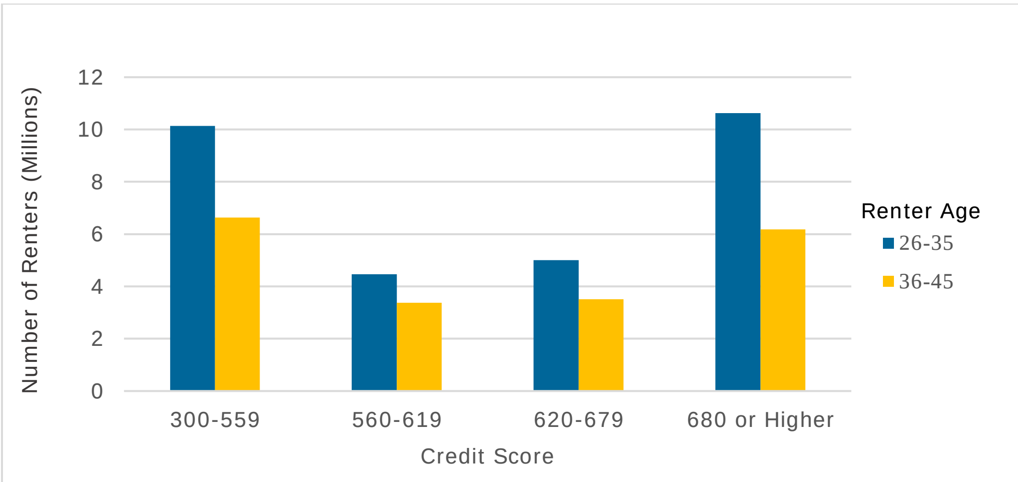
Source: Drew, Rachel. "Effect of Changing Demographics on Young Adult Homeownership Rates." Working Paper. Cambridge, MA: Joint Center for Housing Studies of Harvard University, February 2015.

While some households who are currently renting may still be "sitting on the sidelines" or may not be interested in buying a home, surveys suggest that the vast majority of renters would like to buy a home at some point: according to the National Association of Realtors, 83 percent of renters want to own someday, and 94 percent of renters younger than 35 hope to own in the future.[8]

Yet the barriers to homeownership access are growing. For most U.S. workers, growth in real wages has been flat for decades, and many families are still working to rebuild their employment and credit histories after layoffs, foreclosures, and bankruptcies resulting from the 2007 recession. Additionally, many households have limited savings: the median renter has only $5,400 in assets.[9] Younger households are also increasingly saddled with debt: 40 percent of those between the ages of 20-29 have some amount of student loans, [10] and more than *two-thirds* of college students who graduated in 2014 owe an average of $28,950 in student loan debt.[11]

At the same time, accessing mortgage credit has become more difficult. Many banks have tightened their lending standards in response to losses from the foreclosure crisis, regulatory penalties, and new regulatory requirements. Between 2009 and 2015, lenders made 6.3 million fewer mortgages than they would have if lending standards had been the same as in 2001 (before the subprime boom began).[12] In 2016, the average FICO score needed for conventional purchase loans was above 750, and for FHA loans it was above 680.[13] This puts an FHA or conventional mortgage out of reach for many young households: Figure 2 presents data from the Urban Institute on the distribution of credit scores for renters between the ages of 26 and 45, those most likely to want to buy a home. Only 30 percent have credit scores above 680. Meanwhile, nearly 20 percent of young renters—over 8.5 million individuals—have credit scores between 620 and 680, suggesting that though it is currently just out of reach, they could successfully sustain homeownership with the right mortgage product and support.

FIGURE 2: CREDIT SCORE DISTRIBUTION FOR RENTERS, AGES 26-45



Source: Li, Wei, and Laurie Goodman. "Comparing Credit Profiles of American Renters and Owners," The Urban Institute, March 2016.

Barriers to homeownership are particularly high for Black and Hispanic households, who on average tend to have lower incomes,[14] lower credit scores,[15] and less wealth[16] than White households. This has significant implications for the housing market, as minority households will constitute the largest share of household formation in coming years: by 2024, the U.S. will add between 13.9 and 15.9 million new households, two-thirds of them headed by minorities.[17]

These trends suggest that the need and potential for alternative homeownership models such as lease-purchase to help expand access to homeownership is only going to grow. While sizing the market for lease-purchase is difficult, one industry expert working with existing lease-purchase operators believes that the market need is between $300 billion and $1 trillion in mortgage debt. This aligns with other studies that have estimated the market size of renters who may be held back from homeownership by lower credit scores or other financial barriers. For example, evidence from single-family rental surveys suggest that somewhere between one and three million households are actively working towards buying a home but are uncertain about their financial ability to do so (see Box 1). The Survey of Consumer Finances similarly shows that, in 2013, about 1.6 million renter households with credit problems were saving towards a future home purchase, suggesting they could be helped by a lease-purchase model.[18]

Box 1: The Growth in Single Family Renters

The single-family rental market has seen explosive growth over the past decade; between 2006 and 2014, 3.9 million single-family homes were added to the rental stock. Today, nearly 1 in 5 single-family homes (17 percent) are renter occupied.[a] Single-family rentals are typically larger and more suburban than multifamily rentals, and, as a result, attract renters who are more likely to be married, have kids, be middle-aged, and have higher incomes than multifamily renters.[b]

Single-family renters may prefer to own, but housing costs and their own financial conditions prevent them from buying a home. In a survey of single-family renters of a large, institutional investor, more than half reported wanting to own in the next few years. However, 35 percent responded that they do not believe that they can afford a home, and 15 percent think they cannot qualify for a mortgage. These beliefs are persistent even among higher income families. Among those earning between $75,000 and $100,000, more than 30 percent report not being able to afford a home, and 17 percent do not think they can qualify for a mortgage. Lease-purchase offers one potential route through which these families could access homeownership more quickly.

[a]Jed Kolko, "Housing Highlights from the 2014 American Community Survey," *Terner Center: No Limits Blog*, http://ternercenter.berkeley.edu/blog/housing-highlights-from-the-2014-american-community-survey.

[b] Rachel Drew, "A New Look at the Characteristics of Single-Family Rentals and Their Residents," Joint Center for Housing Studies Working Papers W15–16 (July 2015).

Lease-Purchase Models: Lessons Learned

The concept of lease-purchase—or "rent to own"—is not new, as consumers have long bought everything from clothes to cars to furniture by making smaller, consistent payments before owning a product outright. In the housing market, lease-purchase agreements are generally structured as a rental agreement wherein the tenant has the option to purchase the home after a predetermined amount of time. The contract includes provisions for rent increases throughout the rental period, and an agreement for how the home price will be determined at the time that the tenant buys the home. Rents are typically market-rate, though some nonprofit programs targeting low-income borrowers restrict rents to lower levels. Most programs require tenants to make an upfront "option" payment or an initial deposit to indicate their interest in purchasing the property. In general, this initial deposit is applied to the purchase price when the tenant buys the home. In most programs, tenants need to apply to a bank for a mortgage when they are ready to buy, although sometimes the tenant can “assume” the loan from the landlord.[19] If they decide not to buy the house, tenants can choose not to renew the lease, though under some lease-purchase contracts they may forfeit their initial deposit.

Nonprofit Models

In the late 1980s and early 1990s, lease-purchase activities were largely limited to nonprofits seeking a tool to revitalize distressed neighborhoods. One of the more successful models can be found in Cleveland, where the Cleveland Housing Network has been operating a lease-purchase program using Low-Income Housing Tax Credit (LIHTC) financing since 1987 (See Box 2).[20] New Cities CDC, which operated in the Chicago area, also ran a successful lease-purchase program in the mid-1990s, although an earlier iteration of the program struggled due to the challenges of identifying the right tenants, distressed neighborhood conditions, and managing scattered-site single-family properties.[21] Other nonprofits around the country also ran lease-purchase programs, but the scale of these programs was small and was as much about stabilizing properties and households as it was about providing access to homeownership.[22]

Box 2: Cleveland Housing Network’s Lease Purchase Program

Cleveland Housing Network (CHN) operates one of the most well-known nonprofit lease-purchase programs, converting units developed through the Low-Income Housing Tax Credit program (LIHTC) to lease-purchase. Due to LIHTC’s structure, the units must remain rentals for 15 years, and are rented to low-income tenants earning less than 60 percent of the area median income. At year 16, CHN begins the process of selling the properties to existing tenants and has demonstrated a renter-to-homeowner conversion rate of 85-90 percent. Successfully transitioning a group of properties typically takes three years. In Year 16 (the first year properties are available for sale) approximately half of the families purchase their homes, another 25-30 percent purchase in Year 17 and the remaining homes are sold in Year 18. There are a small percentage of homes (under 10 percent) where the lease purchase tenant is unable to purchase. CHN sells these homes to a curated list of local landlords committed to keeping them as affordable rental property.

As a nonprofit, one of CHN’s primary goals is to provide affordable homeownership options for low-income families. In order to do this, CHN structures its investment such that the remaining debt service on the property in year 15 allows it to sell at a price at which the new homeowners pay roughly the same monthly costs as they did when renting the units. Homes are generally sold below market value—the average sales price is around $29,000—which ensures that homeowners have equity in the property from the beginning. CHN also gives tenants a credit of $1,000 towards purchase for every year they have resided in the unit, up to $10,000. Low-income buyers can sometimes qualify for down-payment assistance through other local, nonprofit, or state funds. CHN also assists tenants in setting up individual development accounts (IDAs) or custodial savings accounts to help save for the purchase. The IDAs established by CHN provide matching funds up to $4,000 if the buyer saves at least $1,000.

Since the first homes became eligible for sale in 2003, CHN has sold nearly 900 homes to former low-income tenants.[a]

[a] Robert Curry and Kate Monter Durban, “Path to Home Ownership: A Guide to Single-Family Lease Purchase Funded with 9% Tax Credits” (Cleveland, Ohio: Cleveland Housing Network, n.d.).

In the wake of the foreclosure crisis, however, interest in lease-purchase grew. In many cities, the concentration of Real Estate Owned (REO) properties, coupled with dramatic declines in house prices, led to a market in which the supply of vacant single-family homes exceeded the demand for families willing and/or able to buy those properties. Self-Help, a community development financial institution (CDFI) in North Carolina, developed a model in which nonprofits would buy homes in neighborhoods with high vacancy and foreclosure rates, rehabilitate them, and then rent them under a lease-purchase structure. In this way, lease-purchase would support neighborhood stabilization (by putting families in vacant homes) as well as allow families to rebuild their credit and financial stability after foreclosure or job loss. The National Community Stabilization Trust (NCST) also proposed a lease-purchase program called HomeStarter, which was designed to target neighborhoods in which the costs of owning were less than the costs of renting. However, neither the Self-Help nor HomeStarter models gained traction and were ultimately replaced by other neighborhood stabilization efforts.

One of the primary limitations for nonprofits seeking to launch lease-purchase programs has been the difficulty in securing the financing to purchase and rehabilitate properties: public subsidies through the Neighborhood Stabilization Program or other sources are often insufficient to purchase properties at scale. In addition, the nonprofit focus on REOs and distressed neighborhoods means that properties often require significant rehabilitation, bringing the total property acquisition and rehabilitation costs above what is warranted by prevailing market conditions.

Other lessons from these nonprofit programs are also important. Acquiring and holding lease-purchase properties—especially at a scale that would bring down transaction and management costs—often poses too high a risk for many nonprofits to take on, especially in declining or stagnant housing markets. Building the capacity of nonprofits to manage scattered-site rentals is critical: lease-purchase and/or scattered-site property management cannot just be an "add-on." It requires designing systems to manage those properties as a separate and distinct asset class.[23] Finally, nonprofits have faced significant challenges identifying tenants who would be ready to buy in one to three years, especially if the tenants had experienced foreclosure.

Private Sector Investment in Lease-Purchase

While nonprofits have largely focused on lease-purchase for neighborhood stabilization, in recent years, private sector investors have stepped into the lease-purchase market in an effort to sell homes. Recognizing the gap between the available supply of single-family homes and households' financial circumstances, these investors see lease-purchase not as a targeted neighborhood revitalization effort, but rather as a way to expand access to homeownership at a scale that also supports their profit goals. Home Partners of America (HPA), based in Chicago, operates its "Lease with a Right to Purchase" Program in over 50 metro areas in 20 states. Another entity, HomeLPC, runs lease-purchase programs in several Texas and Florida metros, along with Seattle. The third company, Trio, is currently active in California, Georgia, and Texas, and plans to expand in several other states in the next 12 months. Trio offers three separate lease-purchase programs, including Trio Access, which is designed to assist households with incomes that are below the area median.

These private sector programs are still new. HPA has been operating lease-purchase agreements since November 2012. In February 2016, HPA securitized a portfolio of 2,232 homes with an outstanding trust balance of just over $500 million. In September 2016 they securitized an additional portfolio of 1,410 homes with an outstanding trust balance of just over $340 million. Since 2012, HPA estimates that among HPA tenants, five percent purchased their homes in the first year of the lease, and an additional five percent purchased in the second year of the lease. Because many of the leases are still in the early years, HPA expects its owner conversion rate to increase, estimating that 30-60 percent of its tenants will buy their homes within five years.

Trio's executive management team has been in the business longer, running a lease-to-own pilot program from 2001 to 2005. Between 2003 and 2007, Trio used Fannie Mae first-time homebuyer products with an added assumption rider to operate a lease-purchase program. Trio's conversion rate in these earlier programs was above 50 percent. Today, Trio's OwnOption Mortgage works with FHA-approved partners and uses FHA mortgages to facilitate a similar lease-purchase mortgage product. Trio completed its first securitization in October 2016 through its participating Ginnie Mae seller/servicer. With its first security completed, Trio is already seeing results: in the first 60 days of their launch in California they received nearly 400 applications for their program. Should interest rates continue to rise, Trio anticipates its conversion rate to exceed 70 percent.

As with nonprofits, the experiences of these private programs provide important insights into the challenges that need to be worked through to make lease-purchase an effective tool for expanding access to homeownership at scale. At the core of a scalable, private lease-purchase program is the balance between investor capital risk and returns and contract terms that benefit the prospective buyer. Three factors in particular influence the risk and return calculus: the cost of capital, the purchase price of the home at the time of the sale to the tenant (or the “strike price”), and investor or nonprofit risk management.

> **Cost of Capital:** The first challenge with the risk and return calculus is the cost of capital in acquiring properties. The cost of capital refers to the opportunity cost of making a specific investment, and determines the rate of return that is required to persuade the investor to make a given investment. The cost of capital depends on the mode of financing, and what proportion of the acquisition costs are financed by debt (which is less expensive) or equity (which is more expensive). If the cost of capital in purchasing a home is high, then rents, fees, and the strike price will all need to be higher in order to generate a sufficient rate of return to the investor (which in turn makes it less affordable to the buying household).

> **Calculating the Strike Price:** The second factor is the expected level of appreciation of the home. In general, the sale price of a lease-purchase property is determined at the start of the lease period. This means that the investor or nonprofit needs to estimate a sale price that: 1) provides an adequate rate of return relative to their cost of capital, 2) factors in the costs related to property management and oversight while the home is being rented, and 3) accurately accounts for anticipated appreciation. If the investor or nonprofit sets the formula for determining the strike price too high (for example, assuming an annual appreciation rate of five percent in a market that instead experiences stagnant house prices), the renter is likely to turn down the option to buy. A high strike price may also prevent the renter from qualifying for a mortgage at the time of purchase, either because their finances cannot support a mortgage that large or because the property does not appraise at the higher value. For this reason, most private lease-purchase programs pay close attention to market conditions and property selection to ensure that the strike price aligns with both affordability and return goals.

> **Investor Risk Management:** The third factor relates to the credit and income of the tenant, and managing the risk that they will either be unable to purchase the home within the given timeframe or will not take good care of the property. If renters cannot obtain financing at the end of the lease term, they will be unable to convert to homeownership and likely will lose their upfront option payments or fees associated with the lease-purchase contract.

While we discuss the issue of cost of capital in more detail below, the three private models studied here approach each of the latter two challenges (strike price calculation and investor risk management) in slightly different ways.

HPA sets its strike price based on total costs, including the initial acquisition of the property as well as costs incurred in getting the property ready for move-in and maintenance.[24] It then builds in an annual increase based on projected home price appreciation in that market. HPA has already made some adjustments to this approach in order to ensure tenants purchase the home; in some of their markets, lower than expected house price appreciation prompted HPA to downshift its increase rate in order to keep the option to purchase as a desirable outcome for the consumer.

Using a different model, HomeLPC relies on an appraisal at the time the tenant wants to exercise the option to buy to determine the strike price. HomeLPC gives the tenant credit for 50 percent of the home's appreciation during the leasing period. In its TrioAccess program, which is targeted to lower-income households, Trio sets its purchase option price equal to today's cost fixed for three years and includes its assumable 30-year OwnOption Mortgage. To ensure its customers are properly prepared when ready to purchase, Trio pays for homeownership counseling services offered by eHome America.

In order to address challenges related to property and tenant selection, private models tend to use a "consumer driven" model, in contrast to the "neighborhood" or property model that underlie most nonprofit programs.[25] In a consumer driven model, prospective buyers apply to the program, and based on their finances, are pre-approved for a maximum monthly rent or a home of a selected amount. The consumer then shops for a home with the help of a realtor and/or homebuilder. Only *after* the home has been selected and appropriate valuations and inspections have occurred does the investor purchase the property.

Though consumers individually select the homes, each organization also has guidelines for the types of homes it is willing to purchase, in an effort to ensure that the home will retain or increase its market value. All three models focus on single-family homes, require that they be in good condition, and Trio requires that the home be no more than 10 years old.[26] HPA requires the home have at least two bedrooms and be on a lot smaller than three acres. They bar properties with guest houses or in-law suites. HPA also requires that homes be within the attendance zone of a high-performing high school (ranked in the top half). This focus on higher-quality properties in better neighborhoods makes lease-purchase more financially feasible to investors without direct subsidy and may provide a bridge to ownership in high opportunity neighborhoods. In comparison, the nonprofit lease-purchase models prioritize community reinvestment as an intended outcome, and so may be targeting underserved neighborhoods, to stabilize them by increasing occupancy.

Consumer driven models also aid in tenant selection and higher conversion rates. Nonprofit programs reported that low rates of conversion into homeownership after the lease period could in part be explained by tenants who wanted to own but not the particular unit or in the neighborhood that the nonprofit had selected. By starting with the tenants rather than properties, the private models are more likely to recruit families who are closer to becoming homeowners, and who are selecting homes that they could imagine buying in the next few years.

Getting Lease-Purchase to Scale

All models—whether nonprofit or for-profit—have struggled with making the economics of lease-purchase work in a way that allows programs to scale up and reach more households. For nonprofits, the key economic challenge has been securing sufficient subsidy for property acquisition and rehabilitation that still keeps the property price in reach of low- and moderate-income households. For the for-profit entities, the primary challenge has been the cost of private investment capital. Because lease-purchase is a relatively new and untested product, sources of capital require a risk premium. Efficient debt financing is critical to successful scaling of lease-purchase, since the required return on equity after leverage for these investments (on a portfolio basis) can range from the mid-teens to more than 20 percent. In addition, most investors are unwilling to commit to a long-term investment.

Further complicating the financial structure is uncertainty over whether the tenant-purchaser can access mortgage financing at the time that they want to exercise the option to purchase. Because conversion to ownership often only occurs three to five years after the lease-purchase contract is initiated, the investor/owner needs to make assumptions about how likely it will be that a tenant will qualify for a mortgage, which is influenced by both the tenant's financial circumstances and the mortgage lending environment. Given that interest rates are likely to rise from their current historic lows, even a modest home price appreciation could mean the monthly mortgage payments will be out of reach in three to five years.

Next Generation Lease-Purchase Product: Introducing the LEAP Mortgage

Increasing the availability of low-cost financing to both lease-purchase operators and would-be homebuyers is an important feature of a program that seeks to scale. To achieve this objective we propose the creation of a LEAP (Lease Equitably and Purchase) mortgage: an assumable, fixed rate, high loan-to-value (LTV) mortgage product that would be available to nonprofits and other entities as part of a lease-purchase program. This type of assumable mortgage product could be offered by FHA as well as by Fannie Mae or Freddie Mac. [27] This is not unprecedented: in 2001, Freddie Mac launched a Lease-Purchase Plus program, which allowed nonprofits and government entities to purchase homes and enter into lease-purchase agreements with potential buyers.[28] However, the program was terminated in the mid-2000s as subprime mortgage lending expanded and lowered demand for the product.

FHA is ideally placed to pilot a LEAP mortgage program. HUD and FHA have successfully used structured pilots in the past to assess the capacity of partners to perform and test new products, such as the Low-Income Housing Tax Credit Pilot and the Small Loan Pilot programs. In addition, FHA has the infrastructure and capacity to develop a lease-purchase product: FHA mortgages are already assumable, the agency has long worked with lenders to serve lower-income or credit challenged borrowers, and the agency's existing regulatory structure can help to ensure that the program is designed in a way that minimizes risk to both consumers and investors. The LEAP mortgage would serve as an extension to the existing FHA 203(b) program, which is already used by nonprofits and government entities to facilitate lease-purchase programs. While FHA's authorizing statute, *12 U.S.C.A. § 1709(g)*, constrains the use of the single-family 203(b) program by "investors," we believe that a well-structured program that limits how long investors can hold the property as a rental and that is designed to ensure the transition to eligible homeowners would meet the legal statutory requirements and fall within FHA's mission to expand access to credit for lower-wealth households.

LEAP Components

FHA LEAP mortgages would be available to both nonprofits and private companies – which we refer to as "Rental Entities" – interested in offering a lease-purchase program. While nonprofits can already use FHA authorities under sections 203(k) and 203(b) of the National Housing Act to acquire properties for lease-purchase, the number of lenders offering the product is limited, and nonprofits can only acquire a maximum of seven properties within a neighborhood, limiting their ability to achieve scale.[29] The LEAP model could therefore help nonprofits who are pursuing neighborhood stabilization and revitalization activities. In addition, by allowing private investors to serve as Rental Entities (without requiring a separate governmental intermediary), the LEAP mortgage would help to scale responsible private sector lease-purchase programs.

During the pilot phase of LEAP, only approved Rental Entities would be authorized to access the product, to protect both FHA and consumers. Rental Entities would need to demonstrate their financial and management capacity to own and manage single-family rental properties, as managing scattered-site single-family homes is more complicated than managing traditional multifamily properties due to the geographic spread of properties and the diversity of maintenance needs. Rental Entities would also have to demonstrate the financial capacity to take on the debt, including "risk sharing" by providing a guarantee during the lease period and meeting minimum capitalization requirements. Capitalization requirements for the Rental Entities could be tiered based on the size of the LEAP portfolio managed.

LEAP mortgages would be offered through select FHA lenders in good standing. FHA lenders approved to offer LEAP mortgages would have to demonstrate experience with and knowledge of existing regulations governing FHA assumable mortgages. Prospective LEAP borrowers would need to meet FHA lending criteria when the mortgage is assumed one to five years down the road, which would require future assumption underwriting.[30] Finally, FHA lenders would also have to demonstrate their capacity and commitment to working with the full range of FHA-eligible borrowers, including those who require manual underwriting due to lower credit scores or higher debt-to-income ratios.

Rental Entities who meet the above criteria and who are working with an FHA-approved lender could then use LEAP mortgages to finance the purchase of the rental property, dramatically lowering their cost of capital.

Rental Entities would not be permitted to use LEAP mortgages to help finance a pool of loans, such as have been issued under the Distressed Asset Stabilization Program. Instead, LEAP mortgages could only be originated at the same time that the Rental Entity has identified a prospective Tenant-Purchaser and is executing the lease-purchase contract. While buying a pool of distressed homes at once often means a lower purchase price for the Rental Entity (and thus the potential for higher returns), it would run afoul of FHA's statute that constrains use of assumable mortgages by investors. By requiring the Rental Entity to identify the Tenant-Purchaser, the FHA 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. In addition, buying properties with an identified Tenant-Purchaser should increase the success of the program in transitioning renters to homeownership. While Rental Entities would not be able to use LEAP mortgages to buy pools of homes, the LEAP program would not place a limit on the number of homes a Rental Entity may hold, allowing both nonprofits and private sector organizations to better achieve scale.

If the Tenant-Purchaser does not purchase the home and assume the loan within the defined program parameters, the Rental Entity must either a) sell the home to a third party and repay the LEAP loan, b) have it assumed by another qualified borrower, or c) repay the LEAP loan and renew the lease to the existing tenant with no lease-purchase option. The purpose of this provision is to ensure that LEAP is not used on a continual basis to finance single-family rentals.[31] While there will always be a number of reasons that Tenant-Purchasers do not convert to ownership—from deciding it is not the right home or neighborhood, to job relocation, to changes in family or economic circumstances—the goal of the program is to facilitate access to homeownership, and the success of the pilot should be measured against the percentage of Tenant-Purchasers who successfully become homeowners. To this end, FHA could allow LEAP mortgages to be used with down payment assistance programs, including those offered through a state Housing Finance Agency. In addition, Rental Entities would be required to provide financial counseling and training to prepare renters for ownership, in partnership with a HUD-certified counseling agency.

Finally, the LEAP program would need to build in provisions to ensure housing quality, affordability, and consumer protections. Homes purchased with a LEAP mortgage must meet FHA minimum property standards at the time that the lease-purchase contract is executed.[32] LEAP would also standardize lease-purchase contracts. Option to Purchase Agreements would specify a maximum upfront cost and a predetermined strike price formula so that Tenant-Purchasers can assess whether they want to participate in the program. Tenants must also be protected from investors who want to hold onto the property to benefit from a longer amortization period or higher house price appreciation. To prevent these longer holds, the Option to Purchase Agreement should include a provision that allows, but does not obligate, the Tenant-Purchaser to buy the property after 12 months.

Upon assuming the mortgage, the Tenant-Purchaser would pay a down payment equal to the difference in the original mortgage amount and the strike price. The strike price formula would be developed to provide for a reasonable return to the Rental Entity for its risk and management of the home, while at the same time ensuring that the final house price is attainable for the Tenant-Purchaser. The standard lease agreement will also lay out the maintenance agreement between the Rental Entity and the Tenant-Purchaser. If the Tenant-Purchaser is responsible for maintenance, a portion of the rent (for which FHA will provide parameters) must be applied to the strike price or returned to the tenant when he moves out. This provision recognizes that the Rental Entity still has property management responsibilities that must be covered by rental payments.

A standardized FHA product would not only be beneficial from the perspective of Rental Entities who can access a product with lower capital costs, but also from the perspective of consumers who will benefit from the standardization built into a federally regulated financial product. While the companies we discussed in this paper are balancing consumer and investor interests, there is evidence that after the housing crisis some investors have used lease-purchase in a predatory manner, marketing low-quality homes to low-income households with contract terms that place much of the risk on the tenants with little certainty that they will ultimately be able to purchase the home.[33]

As currently structured, with private entities only able to access FHA insurance through public entities, FHA may perceive they have appropriate controls on the use of the product, which we believe may provide a false sense of security. There is no evidence that these public entities (often simply single purpose governmental instrumentalities) have the experience or financial capital to operate these programs. To the extent they are successful, it is likely because of a private sector partner. FHA would have better oversight and risk management if it intentionally created the parameters under which the program operates. Tenant-Purchasers using LEAP could also be confident that their lease-purchase contracts meet minimum standards and are designed in a way to maximize the likelihood that they will become homeowners (for example, by including a homebuyer and credit counseling component).

In order to minimize FHA's financial risk, we propose that LEAP be structured as a five-year demonstration project, and annual originations should be limited to a specified percentage of FHA's forward volume. In addition, the demonstration should include an evaluation component to assess the program's efficacy and safety, and to allow for adjustments to the program's guidelines based on the performance of the product.

Conclusion

The decline in the U.S. homeownership rate, as well as the persistent racial gap in homeownership attainment, indicates that more needs to be done to assist families with less wealth in accessing sustainable homeownership. The lease-purchase model offers a potential avenue to making homeownership more accessible without direct public subsidies.

By leveraging private capital, this model has the potential to overcome the income, credit, and down payment constraints many households face in buying their first home.

Certainly, lease-purchase is not a panacea; ultimately, a broader array of products and policies will be needed to expand access to homeownership. For example, efforts to reform the federal housing finance system—including policies related to the GSEs and FHA—should incorporate "duty to serve" principles, to ensure that all households have access to responsible lending products and institutions.[34] Innovations in other mortgage products—such as shared equity homeownership models—could also help bridge the affordability and/or down payment gaps faced by first-time homebuyers. Additionally, investments in neighborhood stabilization and community development can help to ensure that the benefits of homeownership are broadly shared.

However, public policy can play an important role in supporting the development of new private mortgage products, and ensuring they benefit consumers. This is certainly true for FHA, which supported the development of the fixed-rate, 30-year mortgage. FHA already has the authority and infrastructure in place to offer an assumable mortgage, which would benefit both nonprofits and private entities seeking to launch lease-purchase models. In addition, the complexity of lease-purchase—and determining whether it is the best option based on a household's finances and future expectations about mobility and house prices—means that any lease-purchase product needs to be accompanied by transparent contracts, effective regulations, and consumer education. FHA and the Federal Housing Finance Agency are in a unique position to provide that type of stewardship and oversight, as well as help to analyze data and evaluate programs to identify and support the expansion of responsible, scalable models.

While important parameters of the LEAP program must still be worked through in consultation with lending and consumer protection stakeholders, now is the right time for FHA to use its authority to bring an innovative program like LEAP to fruition. This is the type of program that can responsibly, and meaningfully, expand access to homeownership.

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[2] Land installment contracts, or contracts for deeds, are structured as a sale rather than a lease. In this arrangement, the buyer pays the purchase price in installments over a specified period of time, often with a large balloon payment at the end of the term. The seller holds the legal title to the property as collateral until the final payment is made.

[3] For example, in a 2012 study of a county in Texas, researchers from the University of Texas found that among consumers who entered into contract-for-deed agreements, which are a type of land installment contract, fewer than 20 percent converted to homeownership, while 45 percent of the agreements were cancelled. In cancelled agreements, consumers typically lost their entire down payment and all other monies paid on the home during the contract period. See Sarah Edelman, Michela Zonta, and Julia Gordon, "Lease-purchased Failed Before. Can It Work Now?" (Center for American Progress), accessed January 30, 2016, https://cdn.americanprogress.org/wp-content/uploads/2015/04/LeaseToOwn-brief-04.29.pdf.

[4] 12 U.S. Code § 1709(g), Insurance of Mortgages.

[5] United States Census Bureau, Housing Vacancies and Homeownership Table 14. Quarterly Homeownership Rates for the U.S. and Regions: 1965 to Present. Available online at http://www.census.gov/housing/hvs/data/histtabs.html.

[6] The researchers model several potential homeownership trajectories, including one that they dub the "California" scenario. In this scenario, they model the combined impact of rising rent and housing price costs, demographic shifts, and tightened lending conditions. In this scenario, they estimate that the homeownership could decline to 50 percent. Susan Wachter and Arthur Acolin, "Owning or Renting in the US: Shifting Dynamics of the Housing Market," Penn IUR Brief (Philadelphia, PA: Penn Institute for Urban Research, May 2016).

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[17] Lynn M. Fisher and Jamie Woodwell, "Housing Demand: Demographics and the Numbers Behind the Coming Multi-Million Increase in Households" (Washington D.C.: Mortgage Bankers Association, July 2015).

[18] Sarah Edelman, Michela Zonta, and Julia Gordon, "Lease-purchased Failed Before. Can It Work Now?" (Center for American Progress), accessed January 30, 2016, https://cdn.americanprogress.org/wp-content/uploads/2015/04/LeaseToOwn-brief-04.29.pdf.

[19] An assumable mortgage is a type of financing arrangement in which the outstanding mortgage and its terms can be transferred from the current owner to a buyer. By assuming the previous owner's remaining debt, the buyer can avoid having to obtain his or her own mortgage.

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[24] Up to $2,500 can be added to the strike price to defray additional costs if HPA makes capital investments during the tenancy period.

[25] Nonprofits typically purchase homes in neighborhoods targeted for revitalization and/or select properties because they are vacant or blighted.

[26] Trio initially was working directly with homebuilders and focused on new homes, though now they have expanded to include homes up to 10 years old.

[27] The balance of this product discussion will use the assumption that this is an FHA product given the uncertainty in the short-run of whether Fannie and Freddie would be authorized by their regulator to offer a new product.

[28] The program was structured so that at the end of the lease term (three years), the tenants could purchase the home and assume the mortgage, keeping any appreciation the home experienced. The nonprofit provided the down payment on the property as a grant to the homebuyer. Tenants had to undergo both homebuyer and financial counseling.

[29] John O'Callaghan and Paul Weech. 2013. "Policy Lessons from the Neighborhood Stabilization Innovations Initiative," Community Development Investment Review, 9 (2): 7-14.

[30] The cost for such future assumption underwriting could be built into loan rates/fees.

[31] FHA could consider a separate product for this purpose but that is beyond the scope of this paper.

[32] FHA could also create a 203(k) version of LEAP to ensure that needed home improvements are accounted for in the appraisal and purchase price.

[33] Alexandra Stevenson and Matthew Goldstein, “Rent-to-Own Homes: A Win-Win for Landlords, a Risk for Struggling Tenants,” *The* New York Times, August 21, 2016, http://www.nytimes.com/2016/08/22/business/dealbook/rent-to-own-homes-a-win-win-for-landlords-a-risk-for-struggling-tenants.html.

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