Can I Actually Rent - to - Own a Home?

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In today's economy, there are many people who would like to become homeowners but lack the means to do so. For them, a rent-to-own arrangement can appear to be an attractive option. But how do these arrangements work and what are the potential shortcomings?

Though there are variations, the basic lease-with-option-to-buy arrangement works like this: a potential buyer signs a lease to rent a home they are interested in, with the lease typically running two or three years. During that time, the landlord/seller sets aside part of each month's rent payment into an escrow account. When the lease is up, provided the payments have been made in a timely manner, the renter can use the money in the escrow account as a down payment to purchase the home outright.

In another variation, the owner may agree to sell the home to the renter at a discounted price, specified in the agreement, when the lease expires, rather than putting money into an escrow account.

"It's a type of forced savings," said Yael Ishakis, who sometimes handles rent-to-own agreements as part of her duties as a senior loan officer at First Meridian Mortgage in Brooklyn, N.Y. The author of The Complete Guide to Buying a Home, an e-book for potential buyers, she said that many people don't realize how little difference there can be between rent and a mortgage payment.

Ishakis said she recently worked with a client who signed a lease in which they put $5,000 down and agreed to pay $1,800 a month in rent for two years. Of that, $600 a month went into an escrow account. The market rent on the property was actually about $1,600 a month, so the seller/landlord was actually kicking in $400 a month as part of the deal.

"The seller gives a little bit, she (the client) pays a little bit more," Ishakis said.

By the end of the lease, she said, the client had $14,400 in the escrow, plus the $5,000 and another $10,000 they had saved on their own, for a nearly $30,000 down payment.

The downside of a rent-to-buy arrangement like this is that if you don't end up buying the home, you lose the money you've built up in escrow. That could happen if you can't qualify for a mortgage at the end of the lease, if you've simply changed your mind or if you've missed payments that voided the agreement.

Rent-to-buy arrangements are typically offered or accepted by motivated sellers, Ishakis said, those who are uncertain about being able to sell the home or who have had it on the market for awhile. Ishakis said she doesn't see many such deals in a hot market like the New York City area, where demand is high and homes tend to sell fairly quickly. Given the choice, most owners would rather sell the home quickly and be done with it.

How to Find a Rent-to-Own Deal

You can sometimes put together a rent-to-own arrangement by making an offer on a home listed for a conventional sale, but you'll more often find them advertised as such by owners who've decided to go that route. Some companies even specialize in marketing rent-to-own properties.

One such company is RentMACK, a leasing agency that manages about 1,200 single-family homes in the Chicago area.

"We make all of our homes available rent-to-own," said Fermin Saucedo, RentMACK's director of leasing. "We think it creates a real win-win scenario."

Clients who wish to take advantage of the rent-to-own option sign a two-year lease that specifies a pre-determined purchase price, Saucedo said. Those who do have $300 set aside from each month's rent into a special account toward purchase of the home.

"If the tenant is paying on time, we want to reward them for that," Saucedo said.

The rent is the same regardless of whether or not they sign up for the purchase option. At the end of two years, tenants can use the $7,200 they've accumulated toward the purchase of the home.

However, they still have to qualify for a mortgage through a lender. The lease is also non-extendable – if they don't buy the home after two years, they can sign up for a new two-year arrangement but they can't roll over the money they've accumulated – that's lost if they don't buy after two years, as is the case with most rent-to-own arrangements.

Getting the Mortgage

Qualifying for a mortgage at the end of the lease period can be a challenge for many renters who undertake rent-to-own arrangements. If their credit is poor, they'll have a hard time qualifying for a loan and rent payments typically don't help build your credit history. In the time leading up to applying for a mortgage, a renter should consider other ways to build credit – such as using a secured or regular credit card (ideally paid in full monthly), or getting an auto loan with a payment that is well within the borrower's budget.

Renters should also know what credit score range they need to meet in order to get a mortgage, and begin working toward that goal well in advance of applying for a mortgage. (There are free resources that can help future homebuyers track their credit-building progress, like Credit.com.)

Credit isn't the only concern, however. It may also be that the money set aside in the escrow won't be enough for a down payment, something a renter needs to verify before entering the agreement.

Sometimes, there may be an arrangement where the seller acts as the lender, at least temporarily. In that situation, the agreement may be what in some states is known as a land contract, where the buyer agrees to make monthly payments directly to the seller for a certain number of years, then obtain a regular mortgage to buy the home outright.

This may be structured as a loan from the seller with a balloon payment due at the end of the contract period, when the buyer takes out a mortgage on the home to cover the payment.

Again, this type of arrangement can be attractive to buyers with poor credit or who cannot come up with a down payment, as it allows them to build equity in the home until they can qualify for a regular loan. On the downside, the buyer is listed as the owner of the home and is responsible for taxes, insurance, repairs and maintenance during the contract. And if the buyer fails to keep up with the payments, the home reverts to the seller and the buyer loses everything they've invested.

Buyer & Seller Beware

Rent-to-own arrangements can have pitfalls for both buyers and sellers. That's one thing Scott Wallace, CEO of Wallace Property Management Group in Lexington, S.C., stresses when people seek his advice on whether to pursue that route. Wallace, who manages about 350 properties in South Carolina for various owners, learned the hard way a few years ago when he had to foreclose on one of his own properties when a rent-to-own deal fell through.

“Most of the time, they decide it’s not really a route they want to take,” he said. “They don’t want to do it after they’ve had a conversation with me.”

Part of the problem, it seems, is that even with a rent-to-own arrangement, buying a home remains a reach for many renters.

“Most renters are lifetime renters,” Wallace said. “They have every intention of owning a home, but that intention never becomes reality.”

Differences in real estate laws from state to state can change the nature of rent-to-own agreements. In South Carolina, Wallace said, it’s not a good idea for an owner to charge a higher rent for the purpose of placing the difference in an escrow account because if the tenant defaults, a judge might rule the tenant has a property interest in the home.

In that event, instead of merely evicting a tenant, the seller has a more difficult and expensive legal route to pursue, sometimes to the point of having to foreclose on their own property. That’s what happened to Wallace.

If someone does wish to pursue a rent-to-own arrangement, Wallace says he suggests a deal where the seller will rent the property to a tenant for a certain length of time, with the provision they will sell it to them at a pre-determined price at the end of that period.

In any event, he urges that both parties engage attorneys to review the agreement before entering into a rent-to-own deal, to ensure the arrangement passes the “sanity test,” as Wallace puts it.

Beyond that, nothing is set in stone as far as leasing a property with an option to buy. Everything’s negotiable, including the down payment, rent, escrow contribution, lease duration and final selling price. It just depends on how motivated the seller and buyer are, and how much each side is willing to give.

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