BROKER-TO-BROKER ADVICE: FINANCING "RENT TO OWN" PROPERTIES

ARE MORTGAGE BROKERS KILLING THE GOLDEN GOOSE?

A R2O (Rent to Own) financing strategy is something many mortgage brokers use within their tool box, writes **Bruce Smith** of Centum Future Mortgage Group Inc. If done correctly, a R2O strategy can be a win/win for clients, investors, homeowners, Realtors and, ultimately, results in more money in your pocket

With a typical rent to own deal, an investor purchases a property on behalf of the client who rents it for a specific term, until such time as the client can obtain a mortgage and take legal possession of the property. This may be a new property or may represent an existing property, a client cannot refinance under more traditional methods. This method of financing may also appeal to a homeowner as a means of bringing more qualified buyers to the table, or may offer an alternative to the investor who has no interest in the typical tenant/landlord relationship.

The two components to the deal are the "lease" or occupancy component and the "option" or purchase component. We will explore below the benefits of such an agreement, some of the key elements that makes up a rent-to-own agreement, and what pitfalls as mortgage brokers you should be trained to observe and prevent.

BENEFITS OF A RENT TO OWN

For the client – Allows homeownership without the immediate need to qualify for a mortgage. A typical rent-to-own candidate lacks the income, credit or full down payment to qualify for a traditional home purchase. They simply rent the home until such time as they qualify for a mortgage. The investor may assist them in a savings program in order to accumulate the balance of the down payment. The mortgage broker assists with the credit repair. The client benefits from any appreciation in the home beyond the option price and settles into a preferred lifestyle sooner than expected. For existing homeowners, a R20 agreement may prevent loss of the home due to power of sale or failed refinancing attempts.

For the investor – Attracts a better quality tenant during the rental process due to the pride of home ownership. The investor avoids the "nuisance call" from tenants for minor repairs where the client is obligated to repair and maintain the property. Allows the property to be pre-sold, without the need for additional real estate fees. Provides financial protection in the event the homeowner reneges on their responsibilities or fails to exercise the option agreement.

For the Realtor/existing homeowner – Allows them to qualify more purchasers. Clients that can't obtain financing today, may still represent a potential sale opportunity.

For the mortgage broker – A mortgage for your investor and ultimately a mortgage for your client. Two mortgages on the same property, usually within a one-to three-year time period.

KEY ELEMENTS OF A RENT TO OWN

1 Each deal is different based on the needs of the client and the investor so there are no set rules to adhere to. The investor makes money on the resale of the home, or on the monthly rents or both.

2 The resale value is determined at the time of the agreement, or market value can be determined at the time the option is exercised. Best practices suggest the resale value is pre-determined within the option to purchase agreement.

3 The investor typically prefers a non-refundable down payment as security on the deal. As the investor requires a minimum of 20 per cent down to purchase an investment property on behalf of the client, there should be some "skin in the game" by the client, to provide the investor some remedy, should the client not fulfill their commitment.

4 Part of the monthly rental payment is typically applied to the down payment. Rents can be market rents or structured like a mortgage at private lender rates similar to a VTB mortgage. CMHC is very specific in terms of market rents and the need for a portion of the down payment to be refundable in the event the option is not exercised. CMHC's position as provided by Business Development Representative, Joelle Jackson, is below:

Rent should only be accepted to satisfy minimum equity requirements if it is acknowledged in a contractual agreement that includes the prepayment of equity on a monthly basis, as part of an agreement to purchase. This agreement would involve the monthly payment of an amount in excess of the current market rent for the property and would also include at least a partial refund in the event the prospective purchaser does not exercise his/her right to buy. The presence of this provision demonstrates the purchase price is not being over-stated to include the down payment. The amount of equity credited to the prospective borrower should only represent the sum of the amounts by which monthly payments exceed the market rent for the property. Approved lenders should confirm the monthly rent payments are in excess of market rent by reviewing the contractual agreement (e.g. the rent-to-own agreement) which should state the full purchase price of the home, and the portion of the monthly rent payments which are in excess of current market rent. The purchase price submitted by the approved lender should include both the down payment (which has already been paid to the vendor) and the balance owing to the vendor on closing.

5 The R2O deal is structured based on the comfort level and expectation of all concerned, but primarily is structured to facilitate a client deficiency. The client may be deficient in income, down payment or credit so the term of the R2O should provide the client adequate time to correct this deficiency. The expectation should be that the client will correct the deficiency and qualify for a mortgage within the term of the agreement.

6 The process may require the payment of an upfront fee to begin the process for document preparation and to compensate the investor for time spent in a property search. This is viewed as a "commitment" fee and may be applied to the down payment. Best practices suggest that a fee should not be expected to simply review an application. This would be consistent with the practice of not charging upfront fees on a mortgage application.

Where the mortgage community needs to step up is in implementing "best practices" for all R2O transactions. The perception by some, that a R20 is simply a scam to bilk naive "want-to-be homeowners" must stop. As in life there are the unscrupulous individuals which if given a free pass, will "Kill the Golden Goose" for the rest of us. I suggest it is your responsibility as a mortgage professional to recognize what is a quality rent-to-own agreement and what is not.

WHAT A RENT TO OWN IS NOT

1 A VTB (vendor take-back mortgage). If the investor is transferring ownership to the homeowner on day one and holding a mortgage on the property, then this is not a rent-to-own transaction.

2 An arrangement where all rent is applied to the down payment. It seems unlikely that an investor would agree to this when they could simply rent out the property for market rents. Typically some portion of the rent is rebated as a means of assisting in the accumulation of a down payment. All rent may be applied if structured like a VTB mortgage but in most cases a portion of the rent will be applied to the down payment with the exercising of the option agreement.

3 A cash grab for the investor, predicated on the belief that the homeowner will default on their responsibilities. Aside from unscrupulous investors, most participating in this investment vehicle want the property to ultimately sell, as their profit is predicated on a successful transaction. They will not continue to market or resell the property forcing the option to be exercised before the term is up.

4 For properties priced above market value. Investors need to make money on the resale of the property. Price it too high on the resell and the homeowner will never obtain the required appraised valuation required for mortgage financing.

5 Where no consideration is given to the income or creditworthiness of the applicant. As credit is critical to any mortgage transaction, credit management for clients is a must.

6 It only locks you into specific properties owned by the investor. Many investors let you select the property of your choice, as long as it meets their own investment parameters.

7 A deal requiring no independent legal advice. Savvy investors don't want unhappy clients and potential lawsuits so always have clients obtain legal advice by lawyers experienced in rent-to-own transactions.

I hope you found this article informative and beneficial. For more information I suggest you contact associations that are advocates for rent-to-own properties, such as CAROP, (Canadian Association of Rent to Own Professionals). Complete your own due diligence and I believe you will find rent-to-own financing a viable option for clients and investors alike. CMP