# FHA Renovation Loan Program, or 203K

The Federal Housing Administration (FHA), which is part of the Department of Housing and Urban Development (HUD), administers various single family mortgage insurance programs. The Section 203(k) program is the Department's primary program for the rehabilitation and repair of single family properties. The program is designed for **Owner/occupant and qualified non-profit borrowers only**

When a homebuyer wants to purchase a house in need of repair or modernization, the homebuyer usually has to obtain financing first to purchase the dwelling; additional financing to do the rehabilitation construction; and a permanent mortgage when the work is completed to pay off the interim loans with a permanent mortgage. Often the interim financing (the acquisition and construction loans) involves relatively high interest rates and short amortization periods. The Section 203(k) program was designed to address this situation. The borrower can get just one mortgage loan, at a long-term fixed (or adjustable) rate, to finance both the acquisition and the rehabilitation of the property. To provide funds for the rehabilitation, the mortgage amount is based on the projected value of the property with the work completed, taking into account the cost of the work.

## Application Process

This describes a typical step-by-step application/mortgage origination process for a transaction involving the purchase and rehabilitation of a property. It explains the role of HUD, the mortgage lender, the contractor, the borrower, a consultant, the 203K plan reviewer, appraiser and the HUD inspector.

- **Homebuyer Locates the Property.**
- **Homebuyer Selects Mortgage Lender.**
- **Preliminary Feasibility Analysis.** After the property is located, the homebuyer and their real estate professional should make a marketability analysis prior to signing the sales contract. <u>The following should be determined:</u>

  1) *The extent of the rehabilitation work required.

  2) *Rough cost estimate of the work.

  3) *The expected market value of the property after completion of the work. Note: The borrower does not want to spend money for appraisals and repair specifications (plans), then discover that the value of the property will be less than the purchase price (or existing indebtedness), plus the cost of improvements.
  **The process of this step alone will vary widely, depending on the property in consideration. Your favorite Renovation Mortgage Lender should be consulted to assist with this analysis. Their input and guidance now, will save time & money later.*

- **Sales Contract is Executed.** A provision should be included in the sales contract that the buyer has applied for Section 203(k) financing, and that the contract is contingent upon loan approval and buyer's acceptance of additional required improvements as determined by HUD or the lender.
- **Mortgage Loan Application.** The loan documentation is reviewed to determine the maximum insurable mortgage amount for the property. The borrower provides information for the lender to request a credit report, verifications of employment and deposits, and any other source documents needed to establish the ability of the borrower to repay the mortgage and qualify under the 203K program guidelines.
- **Homebuyer and /or Contractor Prepares Work Write-up and Cost Estimate.** An independent consultant or licensed contractor can help the buyer prepare the exhibits to speed up the loan process for smaller jobs. An FHA Plan Reviewer or FHA 203K Fee Inspector will need to prepare the exhibits for larger scale renovations to HUD 203K program specifications. If an FHA Plan Reviewer is also the consultant, then the step (below) can be skipped and the exhibits can go directly to the appraisal stage.
- **FHA Plan Reviewer or FHA Fee Consultant Visits Property.** The homebuyer and contractor (where applicable) meet with the FHA Plan Reviewer to ensure that the architectural exhibits and cost estimates are acceptable and that all program requirements have been properly shown on the exhibits. (Maryland's current list of HUD approved Inspectors and 203K Inspectors will be provided by **ally**mac Mortgage Services)
- **Lender Requests HUD Case Number.** Upon acceptance of the architectural exhibits, the lender requests the assignment of a HUD case number.
- **Appraiser Performs the Appraisal.**
- **Lender Issues Firm Commitment.** If the application is found acceptable and the loan is approved, the firm commitment is issued to the borrower. It states the maximum mortgage amount that HUD will insure for the borrower and the property.
- **Mortgage Loan Closing.** After issuance of the firm commitment, the lender prepares for the closing of the mortgage. This includes the preparation of the Rehabilitation Loan Agreement. The Agreement is executed by the borrower and the lender in order to establish the conditions under which the lender will release funds from the Rehabilitation Escrow Account. Following closing, the borrower is required to begin making mortgage payments on the entire principal amount for the mortgage, including the amount in the Rehabilitation Escrow Account that has not yet been disbursed.
- **Rehabilitation Construction Begins.** At loan closing, the mortgage proceeds will be disbursed to pay off the seller of the existing property and the Rehabilitation Escrow Account will be established. Construction may begin. The homeowner has up to six (6) months to complete the work depending on the extent of work to be completed under HUD's guidelines. (Lenders may require less than six months.)
- **Releases from Rehabilitation Escrow Account.** As construction progresses, funds are released after the work is inspected by a HUD-approved inspector. A maximum of four draw inspections plus a final inspection are allowed. The inspector reviews the Draw Request (form HUD-9746-A) that is prepared by the borrower and contractor. If the cost of rehabilitation exceeds $10,000, additional draw inspections are authorized provided the lender and borrower agree in writing and the number of draw inspections is shown on form HUD-92700, 203(k) Maximum Mortgage Worksheet or Homestyle Worksheet if FNMA eligible.

- **Completion of Work/Final Inspection.** When all work is complete according to the approved architectural exhibits and change orders, the *borrower* provides a letter indicating that all work is satisfactorily complete and ready for final inspection. If the HUD-approved inspector agrees, the final draw may be released, minus the required 10 percent holdback. If there are unused contingency funds or mortgage payment reserves in the Account, the lender must apply the funds to prepay the mortgage principal.

## Eligible Property

To be eligible, the property must be a one- to four-family dwelling that has been completed for at least one year.  Homes that have been demolished, or will be razed as part of the rehabilitation work, are eligible provided some of the existing foundation system remains in place.

## How the Program Can Be Used

This program can be used to accomplish rehabilitation and/or improvement of an existing one-to-four unit dwelling in one of three ways:

- To purchase a dwelling and the land on which the dwelling is located and rehabilitate it.
- To purchase a dwelling on another site, move it onto a new foundation on the mortgaged property and rehabilitate it.
- To refinance existing indebtedness and rehabilitate such a dwelling.

To purchase a dwelling and the land on which the dwelling is located and rehabilitate it, and to refinance existing indebtedness and rehabilitate such a dwelling, the mortgage must be a first lien on the property and the loan proceeds (other than rehabilitation funds) must be available before the rehabilitation begins.

## Eligible Improvements

Luxury items and improvements that do not become a permanent part of the real property are not eligible as a cost rehabilitation. However, the homeowner can use the 203(k) program to finance such items as painting, room additions, decks and other items even if the home does not need any other improvements. All health, safety and energy conservation items must be addressed prior to completing general home improvements.

### Required Improvements

All rehabilitation construction and/or additions financed with Section 203(k) mortgage proceeds must comply with the following:

A. Cost Effective Energy Conservation Standards

(1) **Addition to Existing Structure**. New construction must conform with local codes and HUD Minimum Property Standards in 24 CFR 200.926d.

(2) **Rehabilitation of Existing Structure.** To improve the thermal efficiency of the dwelling, the following are required:

a) Weatherstrip all doors and windows to reduce infiltration of air when existing weatherstripping is inadequate or nonexistent.

b) Caulk or seal all openings, cracks or joints in the building envelope to reduce air infiltration.

c) Insulate all openings in exterior walls where the cavity has been exposed as a result of the rehabilitation. Insulate ceiling areas where necessary

d) Adequately ventilate attic and crawl space areas. For additional information and requirements, refer to 24 CFR Part 39.

(3) **Replacement Systems**.

a) Heating, ventilating, and air conditioning system supply and return pipes and ducts must be insulated whenever they run through unconditioned spaces.

b) Heating systems, burners, and air conditioning systems must be carefully sized to be no greater than 15 percent oversized for the critical design, heating or cooling, except to satisfy the manufacturer's next closest nominal size.

B. **Smoke Detectors.** Each sleeping area must be provided with a minimum of one (1) approved, listed and labeled smoke detector installed adjacent to the sleeping area.

## Required Appraisals

In order to determine the maximum mortgage amount, the 203(k) valuation analysis consists of two separate determinations of value.

A. **As-is Value.** A separate appraisal (Uniform Residential Appraisal Report) may be required to determine the as-is value. However, the lender may determine that an as-is appraisal is not feasible or necessary. In this instance, the lender may use the contract sales price on a purchase transaction, or the existing debt on a refinance transaction, as the as-is value, when this does not exceed a reasonable estimate of value.

Further, on a refinance transaction, when a large amount of existing debt (i.e., first and second mortgages) suggests that the borrower has little or no equity in the property, the lender must obtain a current as-is appraisal on which to base the estimated as-is value.

On a refinance, the borrower may have substantial equity in the property to assure that no further down payment is required on the new loan amount. In some cases, the borrower will not have an existing mortgage on the property. In this case, the lender should obtain some comparables from a real estate agent/ broker to estimate an approximate as-is value of the property.

Another way of establishing the as-is value is to obtain a copy of the local jurisdiction tax valuation on the property.

B. **Value After Rehabilitation.** The expected market value of the property is determined upon completion of the proposed rehabilitation and/or improvements.

## Architectural Exhibits

The improvements must comply with HUD's Minimum Property Standards and all local codes and ordinances. The homebuyer may decide to employ an architect or a consultant to prepare the proposal. The homebuyer must provide the lender with the appropriate architectural exhibits that clearly show the scope of work to be accomplished. The following list of exhibits are recommended, but may be modified by the local HUD Field Office as required.  (Call us for more details regarding these exhibits)

A. **A Plot Plan of the Site** is required only if a new addition is being made to the existing structure. Show the location of the structure(s), walks, drives, streets, and other relevant details. Include finished grade elevations at the property corners and building corners. Show the required flood elevation.

B. **Proposed Interior Plan of the Dwelling.** Show where structural or planning changes are contemplated, including an addition to the dwelling. (An existing plan is no longer required.)

C. **Work Write-up and Cost Estimate.** Any format may be used for these documents, however, quantity and the cost of each item must be shown. Also include a complete description of the work for each item (where necessary). The Rehabilitation Checklist in Appendix 1 of Handbook 4240.4 REV-2 should be used to ensure all work items are considered. Transfer the costs to the Draw Request (form HUD-9746-A).

Cost estimates must include labor and materials sufficient to complete the work by a contractor. Homebuyers doing their own work cannot eliminate the cost estimate for labor, because if they cannot complete the work there must be sufficient money in the escrow account to get a subcontractor to do the work. The Work Write-up does not need to reflect the color or specific model numbers of appliances, bathroom fixtures, carpeting, etc., unless they are nonstandard units.

The consultant who prepares the work write-up and cost estimate (or an architect, engineering or home inspection service) needs to inspect the property to assure: (1) there are no rodents, dry rot, termites and other infestation; (2) there are no defects that will affect the health and safety of the occupants; (3) the adequacy of the existing structural, heating, plumbing, electrical and roofing systems; and (4) the upgrading of thermal protection (where necessary).

## Definitions for Use in the 203(k) Program

A. **Insurance of Advances.** This refers to insurance of the 203(k) mortgage prior to the rehabilitation period. A mortgage that is a first lien on the property is eligible to be endorsed for insurance following mortgage loan closing, disbursement of the mortgage proceeds, and establishment of the Rehabilitation Escrow Account.

The mortgage amount may include funds for the purchase of the property or the refinance of existing indebtedness, the costs incidental to closing the transaction, and the completion of the proposed rehabilitation. The mortgage proceeds allocated for the rehabilitation will be escrowed at closing in a Rehabilitation Escrow Account.

B. **Rehabilitation Escrow Account.** When the loan is closed, the proceeds designated for the rehabilitation or improvement, including the contingency reserves, are to be placed in an interest bearing escrow account insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA). This account is not an escrow for the paying of real estate taxes, insurance premiums, delinquent notes, ground rents or assessments, and is not to be treated as such. The net income earned by the Rehabilitation Escrow Account must be paid to the mortgagor. The method of such payment is subject to agreement between mortgagor and mortgagee. The lender (or its agent) will release escrowed funds upon completion of the proposed rehabilitation in accordance with the Work Write-Up and the Draw Request (Form HUD-9746,A).

C. **Inspections.** Performed by HUD-approved fee inspectors or on the HUD-accepted staff of the DE lender. The fee inspector is to use the architectural exhibits in order to make a determination of compliance or non-compliance. When the inspection is scheduled with a payment, the inspector is to indicate whether or not the work has been completed. Also, the inspector is to use the Draw Request form (Form HUD-9746-A). The first draw must not be scheduled until the lender has determined that the applicable building permits have been issued.

D. **Holdback.** A ten (10) percent holdback is required on each release from the Rehabilitation Escrow Account. The total of all holdbacks may be released only after a final inspection of the rehabilitation and issuance of the Final Release Notice. The lender (or its agent) may retain the holdback for a maximum of 35 calendar days, or the time period required by law to file a lien, whichever is longer, to ensure that no liens are placed on the property.

E. **Contingency Reserve.** At the discretion of the HUD Field Office, the cost estimate may include a contingency reserve if the existing construction is less than 30 years old, or the nature of the work is complex or extensive. For properties older than 30 years, the cost estimate must include a contingency reserve of a minimum of ten (10) percent of the cost of rehabilitation; however, the contingency reserve may not exceed twenty (20) percent where major remodeling is contemplated. If the utilities were not turned on for inspection, a minimum fifteen (15) percent is required. If the scope of work is well defined and uncomplicated, and the rehabilitation cost is less then $7500, the lender may waive the requirement for a contingency reserve.

The contingency reserve account can be used by the borrower to make additional improvements to the dwelling. A Request for Change Letter must be submitted with the applicable cost estimates. However, the change can only be accepted when the lender determines: (1) It is unlikely that any deficiency that may affect the health and safety of the property will be discovered; and (2) the mortgage will not exceed the appraised value of the property less the statutory investment requirement. If the mortgage exceeds the appraised value less the statutory investment, then the contingency reserve must be paid down on the mortgage principal. If a borrower feels that the contingency reserve will not be used and he wishes to avoid having the reserve applied to reduce the mortgage balance after issuance of the Final Release Notice, the borrower may place his own funds into the contingency reserve account. In this case, if monies are remaining in the account after the Final Release Notice is issued, the monies may be released back to the borrower.

If the mortgage is at the maximum mortgage limit for the area or for the particular type of transaction, but a contingency reserve is necessary, the contingency reserve must be placed into an escrow account from other funds of the borrower at closing. Under these circumstances, if the contingency reserve is not used, the remaining funds in the escrow account will be released to the borrower after the Final Release Notice has been issued.

F. **Mortgage Payment Reserve.** Funds not to exceed the amount of six (6) mortgage payments (including the mortgage insurance premium) can be included in the cost of rehabilitation to assist a mortgagor (whether a principal residence or an investment property) when the property is not occupied during rehabilitation. The number of mortgage payments cannot exceed the completion time frame required in the Rehabilitation Loan Agreement. The lender must make the monthly mortgage payments directly from the interest bearing reserve account. Monies remaining in the reserve account after the Final Release Notice must be applied to the mortgage principal.

## Maximum Mortgage Amount

The mortgage amount, when added to any other existing indebtedness against the property, cannot exceed the applicable loan-to-value ratio and maximum dollar amount limitations prescribed for similar properties under Section 203(b). The Mortgage Payment Reserve is considered a part of the cost of rehabilitation for determining the maximum mortgage amount.

A. **Maximum Mortgage Calculation.** The value is defined as the lesser of:

1) The as-is value of the property before rehabilitation plus the cost of rehabilitation; or

2) 110 percent of the expected market value of the property upon completion of the work.

**Principal Residence (Owner-Occupant) & HUD Approved Non-Profit Organization.** For purchases with 203(k) financing: the maximum mortgage amount is to be based upon the HUD estimate of value in 1) or 2) above, less the statutory investment requirement. (3.5% investment as of Jan 1 2009)

B**. Cost of Rehabilitation.** Expenses eligible to be included in the cost of rehabilitation are materials, labor, contingency reserve, overhead and construction profit, up to six (6) months of mortgage payments, plus expenses related to the rehabilitation such as permits, fees, inspection fees by a qualified home inspector, licenses and consultant and/or architectural/engineering fees. The cost of rehabilitation may also include the supplemental origination fee which the mortgagor is permitted to pay when the mortgage involves insurance of advances, and the discounts which the mortgagor will pay on that portion of the mortgage proceeds allocated to the rehabilitation.

C. **Exemption of the Market Value Limitation.** The 203(k) regulations allow for a waiver of the market value limitation, which allows the appraiser to go outside the targeted area to obtain the value of comparable properties. (Contact us for details)

There you have it. If you really did get all the way through this document, by now you have probably figured out; there is more then one reason for working with us on your purchase (or refinance) renovation project. We know the process, we have the resources and our guidance navigating you through the process is free. You can refer to our website specific to renovation loans @ www.renovationloans.com for further information and resources. There are separate sections in our web site for Homeowners and Buyers, Builders and Contractors as well as Real Estate Professionals. Check it out.

I look forward to working with you.

J Child

**ally**mac Mortgage Services

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