Comptroller of the Currency
Administrator of National Banks
US Department of the Treasury

Community Developments

July 2009

Go to page 11 for the OCC's suggestion on Contractor review

Insights

Community Affairs Department

FHA's 203(k) Loan Program

Helping Banks and Borrowers Revitalize Homes and Neighborhoods

Abstract

This *Insights* report focuses on the Federal Housing Administration (FHA) 203(k) Home Rehabilitation Mortgage Insurance Program, an important financial tool that enables borrowers to purchase and rehabilitate properties that might otherwise become or remain vacant.[1] The 203(k) loan program provides government-backed mortgage insurance for a mortgage that combines a property acquisition and rehabilitation loan into one instrument. This product can be used by banks to develop new business, mitigate risk, enhance profitability, and meet certain regulatory requirements, as well as assist in the revitalization and stabilization of neighborhoods negatively impacted by the current foreclosure crisis. The primary purpose of this report is to advise banks of the potential benefits and risks of the 203(k) program and, secondarily, to inform nonprofits and government agencies about the opportunity they have to use this program to preserve single-family homes and revitalize neighborhoods.

The information in this report was obtained by reviewing FHA policies and interviewing financial institutions active in 203(k) lending, 203(k) appraisers, and FHA staff. The terms *banks*, *lenders*, and *financial institutions* are used interchangeably throughout this report. Appendix B provides Web sites with additional information on the 203(k) program.

I. What Is the 203(k) Loan Program?

The 203(k) Loan Program

Congress established the 203(k) loan program in 1978.[2] The program's primary mission is to help borrowers acquire and rehabilitate single-family properties.[3] The 203(k) program can be used to refinance existing mortgages and cover additional rehabilitation costs. Financing purchases and rehabilitation of homes can be costly, time consuming, and complicated. Many home buyers who want to purchase property in need of repair often must obtain three separate loans: short-term financing to purchase the home, another short-term loan to cover the rehabilitation costs,

[1] In this paper, the 203(k) Home Rehabilitation Mortgage Insurance Program is referred to as the 203(k) loan program or simply as the 203(k) program.

[2] See 12 USC §1709(k) and 24 CFR §203.50

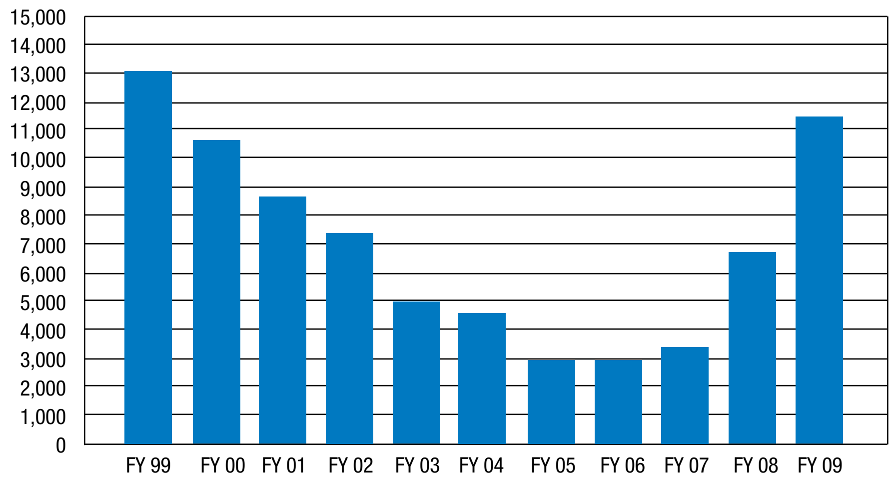
[3] The 203(k) program allows structures with up to four dwelling units to be financed, but the subject property must be owner-occupied or owned by certain eligible nonprofits or government agencies. In 1996, a moratorium was placed on the participation of profit-motivated investors (FHA Mortgagee Letter 96-59, October 29, 1996).

and permanent financing to pay off the first two loans.[4] The 203(k) loan simplifies the home rehabilitation financing process by allowing a borrower to take out one loan to cover the purchase or refinance and rehabilitation costs. A financial institution originates the 203(k) loan, which is fully insured by the federal government at closing, thus minimizing construction-period risk.

The 203(k) program can be combined with other government resources to more effectively rehabilitate foreclosed and vacant homes. For instance, the U.S. Department of Housing and Urban Development (HUD) Home Investment Partnerships (HOME) program and the Community Development Block Grant (CDBG) program can be used to reduce lender risk through a variety of mechanisms. Soft-cost funding from the HOME program or the CDBG program can be used for down payments, credit counseling, or some additional rehabilitation costs.[5] Additionally, the passage of the Housing and Economic Recovery Act of 2008 (HERA) and the American Recovery and Reinvestment Act of 2009 (ARRA) have made available $5.92 billion of Neighborhood Stabilization Program (NSP) monies, which can be used to purchase and rehabilitate foreclosed properties.[6] Combining these resources with 203(k) financing can potentially help revitalize areas negatively impacted by the foreclosure crisis.

While the number of 203(k) loans declined from fiscal years 2002 through 2006, in the past two fiscal years, the program's volume has been on the rise (see Figure 1). In fiscal year 2008, the 203(k) program insured 6,749 loans, nearly double the level from the previous year, and the volume continues to grow in fiscal year 2009. In fiscal years 2008 and 2009, demand for 203(k) loans increased because of limited availability of home equity lines of credit to make property repairs. The program has about $2.7 billion in outstanding home loans insured.[7]

Figure 1: Total Number of 203(k) Loans Originated by Fiscal Year



Source: FHA. FY 09 data as of June 30, 2009.

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[4] Government Accountability Office (GAO). *Homeownership: Problems Persist with HUD's 203(k) Home Rehabilitation Loan Program.* report number GAO/RCED-99-124 (Washington, D.C., 1999).

[5] See 42 USC §5305 and 24 CFR §570.201 for eligible CDBG activities and 42 USC §12742 and 24 CFR §92.205 for eligible activities under the HOME program. See also www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm (link active as of April 14, 2009).

[6] Under the NSP, entities that are granted funds can use these resources to purchase and rehabilitate foreclosed or abandoned properties. See Dan Immergluck, *Community Response to the Foreclosure Crisis: Thoughts on Local Interventions*, Community Affairs Discussion Paper No. 01-08. (Atlanta: Federal Reserve Bank, 2008).

[7] FHA data as of November 11, 2008.

II. Why Is the FHA 203(k) Loan Program of Interest to Banks?

As of June 2009 there were nearly 2 million foreclosed homes.[8] Many of these foreclosed properties are still vacant and in need of repair. Lenders we interviewed suggest that in some housing markets the 203(k) loan is one of the few products available for purchasing and rehabilitating foreclosed properties, particularly if borrowers are unable to make a 20 percent down payment.

Newly enacted federal policy provides new opportunities to offer FHA loans in high-cost areas. On February 17, 2009, ARRA was signed into law. ARRA raised the conforming loan limits for FHA loans in high-cost areas to $729,750. This means that there are more properties and borrowers eligible for 203(k) loans in high-cost markets. Additionally, HERA and ARRA authorized $5.92 billion in funding for acquiring and rehabilitating foreclosed and vacant properties.[9] HERA and ARRA funds can be used in conjunction with the 203(k) program. For example, city governments can use their allocation of funds to acquire foreclosed properties, commonly referred to as Other Real Estate Owned (OREO), and then can rehabilitate these properties with 203(k) financing secured from FHA-approved lenders. They could also undertake such a program in conjunction with a nonprofit organization, which may receive the second round of NSP funds directly through HUD's competitive grant process.

Banks concerned with maintaining collateral values in their residential portfolios might find it advantageous to finance the rehabilitation of blighted or vacant foreclosed properties in communities where they have substantial concentrations of mortgage investments. Research suggests that each foreclosed property in a low- or moderate-income census tract reduces the value of nearby properties by approximately $1,600.[10] The use of 203(k) loans, in partnership with government agencies and nonprofit housing developers, might be one strategy to maintain a bank's residential collateral value, while at the same time helping to stabilize neighborhoods.[11]

New Business Development Opportunities

The 203(k) product offers lenders the potential to serve new borrowers and grow their customer base. The 203(k) program can facilitate homeownership for those with a limited ability to make substantial down payments. The 203(k) program, compared with conventional lending, offers expanded underwriting flexibility, which makes the program appealing to borrowers who may not otherwise qualify for credit. Additionally, borrowers who receive 203(k) loans might establish more substantial bank relationships with additional accounts. The potential opportunity for broadened banking relationships with nonprofit affordable housing developers is another consideration for using the 203(k) program.

Profitability

The 203(k) program can help increase bank profitability in several ways. This product allows banks to earn interest on loans they might not have otherwise made, if they keep the loans in their portfolios. Moreover, there is an active secondary market for FHA loans. The Government National Mortgage Association (Ginnie Mae) permits the placement of 203(k) loans in Ginnie

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[8] See RealtyTrac, http://www.realtytrac.com/TrendCenter/default.aspx (link active as of June 30, 2009).

[9] NSP authorized in 2008 by Public Law 110-289, provides $3.92 billion in CDBG funds for state and local efforts to acquire and redevelop foreclosed properties. In February 2009, Public Law 111-5 authorized $2 billion in additional NSP funding, which will be distributed through competitive grants.

[10] Dan Immergluck and Geoff Smith, *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values* (Chicago: The Woodstock Institute, 2005). For a more recent study on the effect of foreclosures on nearby properties, see Zhenguo Lin, Eric Rosenblatt, and Vincent Yao, "Spillover Effects of Foreclosures on Neighborhood Property Values," *The Journal of Real Estate Finance and Economics 38*, no. 4, (2009): 387-407.

[11] Vikas Bajaj, "Communities Become Home Buyers to Fight Decay," *The New York Times*, August 26, 2008.

Mae securities.[12] Lenders we interviewed say that secondary market transactions typically can generate premiums up to 3 percent of the loan amount, depending on the rate, maturity, and market conditions. Profitability in the secondary market also varies based on the capacity of the lender to service and sell pools of 203(k) loans (see Table 1).

Table 1: 203(k) Estimate of Fee Income

Type of Lender	Loan Amount and Terms	Sales Premium from Investors	Servicing Release Premium	Total First Year Fee Income Received by Originator
Lenders without servicing and pooling capacity	$250,000 at 6%, 30-year fixed rate	50 to 100 basis points $1,250 to $2,500	25 to 50 basis points $625 to $1,250	$1,875 to $3,750
Lenders with servicing and pooling capacity	$250,000 at 6%, 30-year fixed rate	200 to 300 basis points $5,000 to $7,500	44 basis points[a] $1,100	$6,100 to $8,600

[a] The difference between the interest rate and the coupon rate of the Ginnie Mae securities is 50 basis points (bps); 44 bps are collected by the servicing lender, and 6 bps are paid to Ginnie Mae for the guarantee fee.

A 203(k) loan generates more income for lenders than does a typical purchase mortgage because the 203(k) mortgage note rate is generally higher than the market rate. Table 1 illustrates the typical profitability for lenders without and with the capacity to service 203(k) loans and pool them into Ginnie Mae securities.[13] Lenders without servicing and pooling capacities typically sell to other lenders or loan aggregators. Through this process originators can generate, depending on market conditions, an estimated $1,875 to $3,750 for selling a $250,000 203(k) loan with a 6 percent interest rate.[14] The potential profitability of secondary market transactions is higher for lenders that have the institutional capacity to service and sell their 203(k) loans directly to investors. The potential first-year fee income, depending on market conditions, for originators that have the capacity to originate, service, and sell pools of 203(k) loans could range from an estimated $6,100 to $8,600.

Liquidity Management

Liquidity management policies encourage national banks to have sufficient assets on their books that can be easily converted to cash, if needed. As previously mentioned, there exists a secondary market for 203(k) loans. Additionally, smaller banks without secondary market experience can sell their 203(k) loans to other lenders that have greater expertise with Ginnie Mae and institutional investors. Selling these loans, or placing them in Ginnie Mae pools, allows banks to better manage their balance sheet liquidity.

Risk Mitigation and Regulatory Capital Requirements

The 203(k) program provides 100 percent mortgage insurance, backed by the full faith and credit of the U.S. government, against loan default. If a loan defaults, the lender receives from the FHA the remaining unpaid principal balance of the loan. This greatly reduces the risk posed by originating and holding these loans. Under the regulatory agencies' current risk-based capital requirements, these loans are risk weighted at 0 percent compared with higher capital requirements for other types of loans.

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[12] Ginnie Mae guarantees the pass-through and timely payment of interest paid on the principal of the loan by the borrower to secondary market investors. Once HUD endorses the 203(k) loan it can be immediately placed in a Ginnie Mae mortgage-backed security.

[13] Smaller lenders typically do not have the capacity to service 203(k) loans or sell them as pools to investors. Thus, the smaller lenders sell their 203(k) loans to the larger lenders that do have this capacity.

[14] 203(k) loans are typically priced 1 percent higher than standard FHA loans that do not have a rehabilitation component.

Community Reinvestment Act

A bank's originated or purchased FHA 203(k) loans would be considered as home mortgage loans under the Community Reinvestment Act (CRA) lending test applicable to the bank. FHA 203(k) loans to low- or moderate-income individuals or in low- or moderate-income areas may positively affect the geographic distribution or borrower characteristic evaluation of a bank's home mortgage loans. Banks also may receive favorable consideration as a community development service for providing technical assistance on financial matters to nonprofits whose primary purpose meets the CRA definition of community development.[15] For example, a bank may provide technical assistance to a nonprofit that provides affordable housing for low- or moderate-income individuals through the purchase and rehabilitation of foreclosed properties in the bank's assessment area(s) using the 203(k) program. Banks may receive favorable CRA consideration for purchasing mortgage-backed securities that are designed primarily to finance community development, including those collateralized by 203(k) loans to low- and moderate-income borrowers located in the banks' assessment area(s).[16]

Banks may receive positive CRA consideration for certain activities to assist in neighborhood stabilization. Participation in partnerships in which banks make in-kind donations of OREO properties to nonprofits - whose primary purpose is consistent with the CRA definition of community development - might help banks receive favorable CRA consideration.[17] A bank's discounted sale or donation of OREOs in its assessment area(s) to a CRA qualifying nonprofit would receive positive CRA consideration as a qualified investment. Then the bank could provide a 203(k) loan to the nonprofit to facilitate the rehabilitation of this property. The bank, under this scenario, may receive CRA consideration for both its investment and loan.

For more information about CRA examination treatment of 203(k) loans, qualified investments, and community development services, bankers should contact their designated OCC examiner-in-charge or OCC supervisory office.

III. How Does the 203(k) Loan Program Work?

Two Types of 203(k) Loans

The Standard (k) and the Streamlined (k) products allow borrowers to finance the purchase price of the property, closing costs, and repair costs. Another attractive feature of these 203(k) products is that they require only a 3.5 percent down payment on the gross loan amounts. In the private market, conventional rehabilitation mortgages typically require 10 to 20 percent down payment.

Standard (k)

The Standard (k) loan is used when borrowers desire extensive structural work, such as additional room or removal of interior or external walls or when repair costs exceed $35,000. A minimum of $5,000 must be used toward repairs for Standard (k) loans and there is no maximum repair amount. The maximum mortgage, depending on house location, can range from $271,050 to $729,750 (for a more detailed explanation of the mortgage limits, see Appendix C). Further, the loan must not exceed 110 percent of the "as-improved" value.[18] On Standard (k) loans, up to six months of mortgage payments can be financed while the home is renovated and uninhabitable.

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[15] Interagency Questions and Answers Regarding Community Reinvestment, 74 Fed., Reg. 498,512 (January 6, 2009) (Q&A § __.12(i) – 3).

[16] *Ibid*., at 514 (Q&As §__.12(t) – 2). However, banks may not receive CRA consideration if they buy mortgage-backed securities (MBS) that are primarily or exclusively backed by residential mortgage loans that have been considered under the bank's lending test: *Ibid*., at 521 (Q&As § __.23(b) – 2).

[17] *Ibid*., at 514 (Q&As § __.12(t) – 4 & § __.12(t) – 5).

[18] The as-improved value of the home refers to the estimated market value of the home after the rehabilitation work is finished.

The six months of mortgage payments help a borrower pay for housing elsewhere during the rehabilitation phase. For Standard (k) loans, the FHA requires that an FHA-designated consultant write up a rehabilitation work plan before approving FHA insurance. The consultant ensures that properties meet FHA building and local code requirements. See Table 2 for a list of subprograms.

Streamlined (k)

The Streamlined (k) product places fewer demands on the borrower and is designed to assist potential homeowners with less complicated and lower-cost rehabilitation projects. Streamlined (k) loans are recommended for small projects that are mainly cosmetic in nature and do not require structural changes to the house.[19] The maximum repair portion of the loan amount is $35,000, and there is no minimum.[20] Cosmetic improvements may include replacing appliances, flooring, windows, and doors. Borrowers can use this type of loan to replace the heating, ventilation, and air conditioning system, paint the home, or make minor roof repairs. Borrowers using this product are not required to employ an FHA-designated consultant.[21] See Table 2 for a list of subprograms.

Table 2: FHA 203(k) Subprogram Overview

Programs	Maximum Loan Amount	Percent of Insured	Use of Proceeds	Down Payment	Maturity	Maximum Interest Rates	Eligible Property
Standard (k)	Determined by the FHA based on geography,[a] not to exceed $729,750; includes home purchase price, rehabilitation costs, and related finance fees Minimum of $5,000 for repairs	100% of outstanding loan balance	Acquisition of property and substantial expansion or renovation	3.5%	15-year and 30-year fixed or adjustable rates	No maximum rates set by the FHA; market determines price	1-4 unit family properties only, which are owner occupied
Streamlined (k)	Determined by the FHA, based on geography, not to exceed $729,750; includes up to $35,000 for repairs and related finance fees Maximum of $35,000 for repairs	100% of outstanding loan balance	Acquisition of property and cosmetic or minor improvements	3.5%	15-year and 30-year fixed or adjustable rates	No maximum rates set by the FHA; market determines price	1-4 unit family properties only, which are owner occupied

[a] For more on the FHA loan limits, see Appendix C and https://entp.hud.gov/idapp/html/hicostlook.cfm for the loan limits for specific geographies (link active as of April 13, 2009).

[19] Structural change refers to the removal of walls or supports, which can compromise a building's structural soundness.

[20] The $5,000 minimum requirement for the Streamlined (k) was removed in 2005 (FHA Mortgagee Letter 05-50, December 29, 2005).

[21] Some lenders we interviewed require a professional consultant to review the repair plans as a safety and soundness measure even though the FHA does not mandate this for Streamlined (k) loans.

Eligible Borrowers

Borrowers who meet the underwriting qualifications for the 203(b) FHA mortgage insurance program are eligible to receive 203(k) loans.[22] These borrowers must occupy the home financed under this program. Profit-motivated investors are ineligible for 203(k) loans.[23] Certain nonprofits and government agencies are eligible borrowers. The FHA must approve, through its Homeownership Centers, nonprofits and government agencies before they can receive 203(k) loans.[24] This provides an opportunity for nonprofits to access financing to restore foreclosed properties. Nonprofits can use the program to rehabilitate foreclosed FHA-owned, city-owned, and OREO properties. However, there are restrictions for nonprofit developers and government agencies. These entities may not have more than 10 incomplete 203(k) properties at any one time.[25] Also, the down payment required is higher. A 3.5 percent down payment is required for individuals, but nonprofits and public agencies must put down 5 percent.[26]

Eligible Properties

To qualify for the program, properties must be one- to four-family dwellings that have been completed for at least one year. The program can be used to convert a single-family unit into a two-, three-, or four-family dwelling or convert a multidwelling building into a single-family home, as long as the borrower intends to be an owner-occupant. Any newly constructed units must be attached to the existing dwellings. Demolished homes are eligible as long as part of the existing foundation remains intact. The number of units must comply with local zoning. Mixed-use properties qualify as long as no greater than 25 percent (for a one-story unit); 33 percent (for a two-story building); or 49 percent (for a three-story building) of floor space is designated for commercial use. For these properties, rehabilitation funds must be used exclusively for the residential portion of the unit or for accessing the residential space. Cooperative units are ineligible, but condominium units, with some restrictions, qualify.[27]

Eligible Uses

There are several eligible uses for 203(k) loans.[28] Some typical uses include room additions, deck installation, or replacing the heating and air conditioning systems. Certain repairs must be completed before other cosmetic improvements can occur. However, the cosmetic improvements

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[22] The 203(b) FHA mortgage is the standard FHA mortgage; it does not include rehabilitation funds.

[23] Borrowers can own additional properties, but they must live in the homes financed FHA loans. Nonprofits and government agencies can be borrowers as well.

[24] FHA's Homeownership Centers can be found at http://www.hud.gov/offices/hsg/sfh/hoc/hsghocs.cfm (link active as of April 5, 2009).

[25] FHA defines completed 203(k) developments as those that have completed all rehabilitation and construction, properties sold, and loans paid off or the properties are tenant-occupied and rent revenue exceeds all property expenses (FHA Mortgagee Letter 00-8, March 3, 2000). There is a geographic limitation on the number of 203(k) loans that can be originated. No more than seven units with 203(k) loans within a two-block radius can be under rehabilitation/construction at one time.

[26] Some lenders we spoke with had reservations about extending 203(k) loans to nonprofits. They indicated that only nonprofits with sufficient real estate construction and housing sales experience, in addition to a strong connection to local government agencies, should be considered for this program.

[27] 203(k) financing can only be used for the interior improvement of condominium units. Additionally, the maximum mortgage amount for a condominium cannot exceed 100 percent of the as-improved value of the unit. There are other restrictions on using the 203(k) program for condominium rehabilitation; those interested in using this program for condominium should refer to www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm (link active as of April 14, 2009).

[28] Ineligible uses include luxury items such as swimming pools, exterior hot tubs, and saunas. For a complete list of ineligible uses see chapter 1 of FHA's 203(k) Handbook at http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4240.4/index.cfm (link active as of April 14, 2009).

may be added after the $5,000 threshold has been exceeded.[29] In addition, the program attempts to promote energy conservation and renewable energy upgrades. Cost-efficient energy conservation is stressed; weather stripping and ensuring the integrity of the building's envelope, through sealing and caulking cracks and joints, is mandated. See Table 3 for example of eligible uses.

Table 3: Some Eligible Improvements with Standard (k) and Streamlined (k) Loans

Standard (k)	Streamlined (k)
Additional rooms	Minor roofs, gutters, and downspouts repair
Well or septic system	Interior or external painting
Replacement of all plumbing	Minor plumbing and electrical work
Major chimney repairs	New flooring (carpet, wood, tile)
Major roof, kitchen, and bath work	Minor kitchen and bath remodeling

Preliminary Steps for Borrowers

Several steps and procedures need to be followed to complete a successful 203(k)-financed home rehabilitation projects. Borrowers, most likely working with real estate agents, will locate properties to purchase and rehabilitate as well as find FHA-approved lenders. The FHA offers a Web-based search tool to help borrowers find FHA-approved lenders in their areas.[30]

FHA Designation for Lenders

Lenders must be FHA-approved to offer any FHA products, including 203(k) loans. A bank applies directly to the FHA to receive authorization to make 203(k) loans.[31] Once the bank's application is received, it typically takes the FHA between 30 and 45 days to process the application and make the final decision to approve the bank loan. Lenders pay a $1,000 FHA-designation application fee.[32]

Consultants and Appraisers

Before loan closing, the borrower, or a 203(k) FHA-approved consultant mandated under the Standard (k) program is required to write up an in-depth construction plan, with architectural exhibits and an accurate cost assessment.[33] Once the write-up is complete, an FHA-approved appraiser must determine the estimated value of the property after work is completed.[34] While taking into account the FHA loan limits, the lender uses the appraisal, along with the original loan application documents, to determine the maximum insurable mortgage amount. Based on this evaluation, the lender issues a commitment letter to the borrower and prepares for the closing date.

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[29] Pursuant to FHA Mortgagee Letter 94-1, March 17, 1994, fencing, new walks or driveways, and general landscaping work, such as trees, shrubs, seeding or sodding, cannot be included in the first $5,000 threshold.

[30] See www.fhaoutreach.gov/lender/lender.do (link active as of April 14, 2009).

[31] More information about the lender application process is available at http://portal.hud.gov/portal/page?_pageid=73,1826370&_dad=portal&_schema=PORTAL (link active as of April 20, 2009).

[32] There is an additional $250 application fee for lenders who want to be Ginnie Mae-approved. This approval process allows lenders to issue Ginnie Mae securities.

[33] 203(k) FHA-approved consultants can be found at https://entp.hud.gov/idapp/html/f17cnsltdata.cfm (link active as of April 14, 2009). FHA-approved consultants conduct cost-estimating that is validated against industry-published tables from RS Means, Marshall Swift, and Hometech to ensure pricing accuracy in the marketplace where the properties are located.

[34] Find FHA-approved appraisers at https://entp.hud.gov/idapp/html/apprlook.cfm (link active as of April 14, 2009).

Underwriting

The FHA relies on an automated underwriting TOTAL Mortgage Scorecard and FHA-approved Direct Endorsement (DE) underwriters to make credit decisions concerning 203(k) loans.[35] Lenders must submit information about the borrower, loan, and property via an automated online underwriting system. The automated system performs an initial determination as to whether the borrower has the ability to repay the loan. Applications not initially qualified through the automated system are referred to the FHA's cadre of DE underwriters who manually review the application to determine credit risk.[36] Regardless of the risk assessment approach used, the originator remains responsible for compliance with FHA eligibility requirements, as well as for any credit, capacity, and documentation requirements.

Closing 203(k) Loans

Closing an FHA 203(k) loan is similar to any typical FHA loan closing except for the Rehabilitation Loan Agreement and the establishment of a Rehabilitation Escrow Account. The Rehabilitation Loan Agreement between the borrower and the lender establishes the conditions under which the lender releases the rehabilitation funds. The borrower is required to make mortgage payments to the lender based on the entire outstanding principal amount, including the escrow account balance that has not yet been disbursed. However, under the Standard (k), a borrower may include up to six months of mortgage payments in the rehabilitation budget to cover these payments during the rehabilitation period while the property is uninhabitable. After the closing, the bank submits copies of the mortgage documents to the FHA, and FHA mortgage insurance becomes effective immediately upon endorsement.[37] Lenders submit their documentation materials through FHA's online servicing system, known as FHA Connection.

Construction Phase

The FHA requires that borrowers complete the rehabilitation in six months. Some lenders may establish a shorter construction period depending on the amount of work needed. As construction progresses, the bank disburses funds from the Rehabilitation Escrow Account after the completed work has been reviewed by an FHA-approved inspector.[38] A 10 percent holdback is placed on construction phases until all outstanding contracts are complete.[39] The FHA allows for four draws, plus a final inspection, from the Rehabilitation Escrow Account during the construction phase.

Final Inspection

When repairs are finished, the borrower requests a final inspection. Upon final inspection, all the funds from the Rehabilitation Escrow Account, including the required 10 percent holdback, are released. If there is money left in the escrow account, the borrower may apply the funds to pay down the mortgage principal or, alternatively, the funds may be used for additional improvements not included in the initial plans. See Figure 2 for a flow chart of a Standard (k) loan.

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[35] See FHA TOTAL Mortgage Scorecard User Guide and FHA Mortgage Letter 2004-47 at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/04-47ug.doc (link active as of April 14, 2009).

[36] More information on FHA's DE underwriters is at www.hud.gov/offices/hsg/sfh/f17c/f17under_xmlhlp.cfm (link active as of April 20, 2009).

[37] Once the loan closes, the lender has the ability to sell the loan. The Government National Mortgage Association (GNMA) permits Section 203(k) mortgages to be placed in either GNMA I and II pools along with Section 203(b) mortgages.

[38] Find FHA-approved inspectors at https://entp.hud.gov/idapp/html/insplook.cfm?in_fha=No (link active as of April 20, 2009).

[39] For properties older than 30 years with repairs above $7,500, the FHA requires borrowers to have contingency reserves, ranging from 10 to 20 percent of the construction budget, to cover potential cost overruns. This requirement is only for the Standard (k) product and does not apply to the Streamlined (k) loans.

Marketing

Our interviews with lenders indicate that 203(k) customers are sourced in one of two ways. Many 203(k) lenders establish relationships with local real estate agents who specialize in locating properties in need of repair. Some lenders attend professional association meetings of real estate agents to market 203(k) products. Because many borrowers are unaware of the 203(k) program, banks often market this product to customers who initially seek conventional financing on properties that might need improvements.

Bank Administration of the Program

The number of lending staff dedicated to 203(k) products depends on a bank's business model and whether government lending is central to its overall strategy. One key to offering 203(k) loans successfully is to have the capacity to appropriately approve and monitor construction draws. Some banks do this internally and have a separate construction draw unit; others outsource this function for a premium, typically 1 percent of the total loan, to other lenders. Because the number of 203(k) loans originated is usually small, lenders typically have one to two staff members who specialize in originating, underwriting, and administering these loans. With 203(k) volume increasing, lenders we spoke with are considering hiring additional staff with 203(k) product experience.

Figure 2: How a Standard (k) Loan Works

A borrower finds a home to purchase and rehab (or seeks to rehab and refinance current residence).

A borrower works with an FHA-approved lender.

Borrower, contractor, and an FHA-approved consultant meet at the property to determine "required vs. desired" improvements.

The fee consultant prepares the work write-up.

Lender gives the construction plan to FHA-approved appraiser to determine "as-improved" value.

TOTAL Scorecard or DE underwrites the loan, if approved closing scheduled.

The loan is closed. Funds are set aside in escrow accounts. The loan is FHA insured after closing.

The work begins. Borrower/contractors are paid in draws as the FHA fee consultant approves draw requests for completed work.

After work completed lender releases 10 percent holdback on all contracted work.

IV. What Are the Key Risks and Regulatory Considerations of the 203(k) Loan Program?

Underwriting

FHA's automated underwriting system and FHA's approval process for DE underwriters help ensure that 203(k) loans are originated in a safe and sound manner. Most lenders we interviewed note that their 203(k) portfolios had a slightly higher default rate than their traditional FHA loans. However, the FHA's guidelines help ensure that borrowers have sufficient ability to repay 203(k) loans. FHA loans are 100 percent insured when the loans close.

Construction Risk

The construction phase (the first six months of a loan) presents the highest risk of loan default. It is important to note that this risk is mitigated for the bank because, upon closing, 203(k) loans are 100 percent FHA insured. However, trouble can arise because of construction cost overruns, which might prematurely deplete the escrow account and leave borrowers at risk of being unable to pay. Lenders we interviewed suggest that a thorough review of the selected contractors is critical to increasing the probability that a project will be completed on time and on budget. This includes reviewing the contractors' references and disclosures and ensuring that contractors have all necessary work permits before the loan closing. Lenders also recommend that proposed changes to the price of the rehabilitation work be carefully examined. For example, if a repair plan initially comes in at $50,000 and the borrower does not have sufficient income to service the total loan, the borrower, with a revised estimate from their contractor, might reapply for a lower mortgage amount. If the construction plan has not substantially changed, the lender should scrutinize the reasonableness of the lower request.

The 203k Contractor Education & Certification Program already does this for Lenders. Go to http://203kContractors.com for more information.

Reputation Risk

Ten years ago, certain lenders and nonprofits stigmatized the 203(k) program by using the program for fraudulent purposes.[40] While the 203(k) program has operated more effectively over the past decade, those we interviewed noted that lenders must conduct due diligence to ensure loan eligibility. Some lenders say that investors may occasionally try to obtain 203(k) loans, and banks must conduct proper checks to make certain that borrowers will occupy the homes. In addition, banks offering the 203(k) loan program via third-party relationships must conduct due diligence in selecting reliable partners that have the capacity to originate and manage the program effectively.

Some lenders we interviewed suggest that increased oversight of consultants and appraisers is needed. A lack of oversight increases the opportunity for fraud. In the past, according to those we interviewed, the FHA randomly checked on project sites to ensure that repairs were complete. More recently, oversight has decreased. Some interviewees stress that increased FHA oversight of consultants might reduce risk associated with the program. The FHA does not provide insurance on loan defaults stemming from fraud.

Default Management Risk

Lenders must carefully follow the FHA loan servicing guidelines to obtain reimbursement for their full insurance claim if borrowers default on 203(k) loans.[41] Lenders should have effective quality-control procedures to ensure that FHA guidelines are followed throughout loan origination and foreclosure processes. Lenders who do not fully comply with these guidelines could impair their mortgage insurance claims and possibly incur HUD financial penalties.[42]

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[40] Kemba Johnson, "The Harlem Shuffle," *City Limits*, November 1999.

[41] For 203(k) loan origination and servicing rules, see FHA's 203(k) Handbook at http://www.hud.gov/offices/adm/hud-clips/handbooks/hsgh/4240.4/index.cfm (link active as of April 14, 2009).

[42] Rebecca Walzak, "Pitfalls of FHA," *Mortgage Banking*, March 2009.

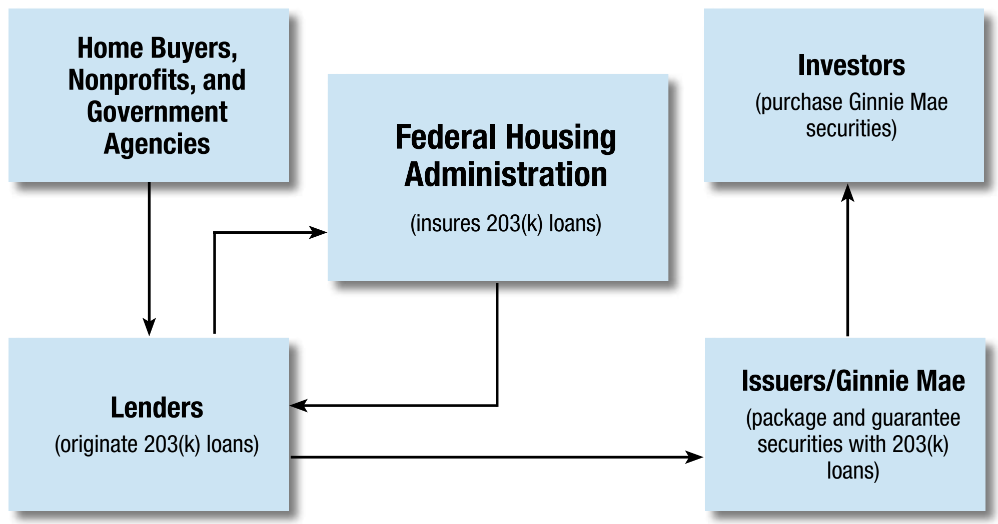
Compliance and Fair Lending Risk

Financial institutions offering FHA 203(k) loans must ensure that they do so in a manner that complies with the applicable laws and regulations, including the following federal laws: Equal Credit Opportunity Act, Fair Housing Act, Truth in Lending Act, Real Estate Settlement Procedures Act, National Flood Insurance Act, and Federal Trade Commission Act (Section 5).

V. Who Is in the 203(k) Loan Business Today?

A diverse group of individuals and institutions make up the 203(k) industry. They include home buyers, nonprofits, lenders, the FHA, Ginnie Mae, Ginnie Mae securities issuers, and investors (see Figure 3). While the FHA and residential lenders are central participants, other entities, such as Ginnie Mae, and institutional investors are critical to the proper functioning of, and demand for, the 203(k) product line.

Figure 3: Credit Market Participants for the 203(k) Program



Home Buyers, Nonprofits, and Government Agencies

Individual homebuyers, nonprofits, and government agencies are eligible to receive 203(k) loans. According to the lenders we interviewed, those driving the growth in the 203(k) area are first-time home buyers who lack sufficient down payments (i.e., less than 20 percent) and are purchasing foreclosed properties.[43] Nonprofits and local governments have access to HUD-owned real estate that can be purchased at a significant discount, sometimes as low as $1, through the 602 Nonprofit Disposition Program.[44] Local governments can combine 203(k) financing with other federal funds, such as HOME, CDBG, and NSP, to purchase and rehabilitate bank-owned or HUD-owned properties.[45] A few state housing finance agencies have initiatives to help new homeowners

[43] Lenders interviewed indicate that those who want to upgrade but are unable to sell opt to take out 203(k) loans to renovate or expand their homes.

[44] Kenneth Temkin, Mark Turner, Laurel Davis, Larry Buron, and David Rodda, "Assessment of the 602 Non-Profit Disposition Program," prepared for HUD, Washington, D.C., 2006 and Kevin Duffy, "For Right Buyer, HUD a $1 Store," *The Atlanta Journal-Constitution*, November 5, 2008.

[45] See Vikas Bajaj, "Communities Become Home Buyers to Fight Decay," The New York Times, August 26, 2008 and Margot Carmichael Lester, "Sign of the Times - Five Cities Bringing New Life to Abandoned Sites," Developer Online, August 11, 2008, available at www.developeronline.com/sign-of-the-times-five-cities-turning-around-abandoned-sites/ (link active as of April 20, 2009).

purchase vacant properties. Greater use of the 203(k) program might help strengthen local rehabilitation efforts, which are beginning to emerge throughout the country.[46]

Lenders and the FHA

The 203(k) loan market has more than 275 participating lenders, including large and smaller national banks and independent mortgage companies. The FHA works with its set of approved lenders to offer this product.

Issuers, Ginnie Mae, and Investors

Issuers, including such conduits as loan aggregators or investment banks, Ginnie Mae, and investors are important secondary market participants, who, to a certain extent, dictate lender volume and ability to offer 203(k) loan products. Lenders that generate higher loan volumes issue Ginnie Mae securities. Many lenders originating smaller volumes of 203(k) loans sell them to mortgage lending aggregators or investment banks, who bundle these loans and issue Ginnie Mae securities, backed in part by pools of 203(k) loans. While the FHA insures the underlying loans against borrower default, Ginnie Mae guarantees timely pass-through and payment of interest from the mortgage servicers to Ginnie Mae investors. The market for certain conventional mortgage-backed securities has declined; however, there is still an active market for Ginnie Mae securities because they are backed by the full faith and credit of the U.S. government.

VI. How Does the 203(k) Cost Structure/Pricing Work?

Pricing and Terms

The FHA does not establish pricing for FHA loans. The FHA only sets the amount charged for the FHA mortgage insurance. Lenders price FHA loans so they are competitive products in the overall mortgage market. Because of the higher administrative cost of managing the rehabilitation phase, the interest rate charged by lenders for 203(k) loans is typically priced about 1 percent higher than regular FHA 203(b) loans. Lenders can offer 15- or 30-year term 203(k) loans and the interest rate can be variable or fixed.

Loan Limits

The FHA sets maximum loan limits by the geographic location of the property and lenders must structure their 203(k) loans within these limits. Maximum loan limits range from $271,050 in low-cost areas to $729,750 in high-cost areas for single-family properties.[47] For Standard (k) loans, the improvement portion of the loan has no limits, but the total purchase and rehabilitation amount must not exceed the allowable maximum loan limit for the particular geographic region. For Streamlined (k) loans, the rehabilitation portion of the loan cannot exceed $35,000, but maximum loan limits still apply.

Insurance and Construction Related Fees

There are several fees associated with 203(k) loans. The lender is permitted to charge the borrower a supplemental origination fee; the greater of 1.5 percent of the rehabilitation portion of the loan or $350. There is an FHA up-front insurance fee of 1.75 percent of the total loan charged to the borrower, which can be financed in the overall loan amount. There is also an annual FHA mortgage insurance premium, charged to the borrower, of 55 basis points of the outstanding loan balance. The mortgage insurance premium is necessary to ensure that the FHA has adequate reserves to cover loan defaults.

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[46] State and local efforts to revitalize vacant and foreclosed homes are occurring in Cleveland, Dallas, Detroit, Massachusetts, Milwaukee, Minneapolis/St. Paul, New York City, Rhode Island, and Washington, D.C. See Living Cities, *Mitigating the Impact of Concentrated Foreclosures on Neighborhoods*, Washington, D.C., 2008, Joanne Cleaver, “WHEDA Pairs First-time Buyers, Foreclosed Houses,” *The Milwaukee Journal Sentinel*, May 18, 2008, and Sharon Canavan, “Property Disposition: Exploring Different Approaches to Preserving Affordable Housing Opportunities,” OCC, March 2009.

[47] These mortgage limits are effective through December 31, 2009. See FHA Mortgagee Letter 2009-07 for more details.

Certain fees accompany the construction and repair process. For Standard (k) loans, an FHA-approved fee consultant is needed to complete the work write-up. The fee for this service is up to a maximum of $500 and is determined on a sliding scale based on the cost of the work. Additionally, when a draw is needed from the escrow account to pay a contractor, an FHA-approved fee consultant is required to review the work before release of the funds. Each inspection costs $50, and the FHA allows up to five inspections. These costs are paid by the borrower, and it is permissible to finance these expenses in the rehabilitation portion of the loan. Lenders must have an FHA-approved appraiser estimate the "as-improved" value of the home. The bank is responsible for hiring the appraiser, and the cost is passed on to the borrower. Appendix A illustrates the primary customary 203(k) loan fees.

VII. What Barriers Have Constrained the Growth of the 203(k) Product?

FHA Repair Guidelines

FHA guidelines mandate that properties must meet minimum health and safety standards before cosmetic repairs are made. Those using the Standard (k) product have an FHA consultant who requires that repairs meet these standards as well as local code requirements. These requirements may add unexpected costs to rehabilitation projects, particularly for older residences.

Minimal Construction Experience

Some banks do not have adequate home construction lending and management experience. Lacking this experience, lenders might not have the capacity to anticipate problems that may arise during the construction phase. The largest originators of 203(k) loans have the necessary infrastructure, such as a draw center to administer the escrow accounts, as well as experienced staff to oversee the construction phase. Some banks might find the expense to establish this experience and infrastructure too costly relative to their expected 203(k) volume.

Length of Time to Close

Some real estate agents and lenders do not like to use the 203(k) program because they perceive that it takes too long to close these loans. Our interviewees estimate that it takes between 45 and 90 days to close a 203(k) loan, depending on the scope of the work and the capacity of a lending institution. Because loan officers and real estate agents want to close loans efficiently and rapidly, they often overlook the 203(k) program. However, in today's market the 203(k) product might be the only loan product that fits the needs of a particular borrower set. As the number of foreclosed properties in need of repairs increases, loan officers and real estate agencies may find it makes business sense to finance homes with 203(k) loans.

Altering the Streamlined (k) Product

Some lenders we spoke to report that the FHA should mandate inspections for each draw made under the Streamlined (k) product. Lenders say that the Streamlined (k) product makes it easier for borrowers but is riskier for originators because it does not mandate the use of FHA-approved inspectors before each release of funds from the escrow account. This increases the chance that borrowers may use the loan proceeds for purposes other than home improvement items. However, this risk is often mitigated by lender-driven checks on contracted work. Some lenders we spoke to establish their own required inspections for Streamlined (k) draws.

Investor Participation

Investors or nonowner occupants (except for nonprofits and government agencies) are prohibited from participating in the 203(k) program. However, several lenders believe that the FHA and Congress should reconsider permitting profit-motivated investors to participate again, provided there is adequate supervision. The number of vacant and foreclosed homes has increased significantly, and certain lenders believe that investors have a greater capacity and experience to efficiently repair and manage these properties.

VIII. Conclusion

If used effectively, the FHA 203(k) loan program can be an important tool to improve residential properties, preserve homeownership, and revitalize neighborhoods. By simplifying the loan approval process and providing 100 percent insurance, the program reduces risk and provides liquidity while enhancing loan profitability and regulatory compliance. Moreover, in today's market, the 203(k) product may help banks reduce their inventory of foreclosed properties and minimize the number of deteriorating properties throughout the country.

Banks can also use the 203(k) product to develop new business and grow their customer base, especially in high-cost areas or markets where borrowers are unable to make large down payments. New federal funding and regulations provide opportunities to broaden banking relationships with state and local governments and nonprofit organizations. Banks may also receive positive CRA consideration for originating or purchasing 203(k) loans, especially to low- or moderate-income individuals or in low- or moderate-income geographies in the bank's assessment area(s). Few conventional home purchase and rehabilitation loan products can offer the same flexibility, guarantees, and return.

Appendix A

Examples of 203(k) Fees and Loan-to-Value

Basic Costs	
Purchase price	$200,000
Rehab work	$ 50,000
Overall 30-year fixed-rate mortgage (less 3.5% down payment of $8,750)	$241,250
Mortgage rate: (based on HUD estimate that rates average 1% more than standard FHA rates, currently 5%)	6%
Closing costs, upfront insurance premium, etc. (see additional fees)	$ 7,221
FHA annual insurance fee (55 basis points of the outstanding loan balance)	$ 1,366 ($114 in monthly installments)
Monthly payment	$ 1,604
Additional Fees	
The write-up fees and other charges may be rolled into the rehabilitation portion of the loan. The closing costs and the up-front insurance premium can be included in the loan as well. Standard (k) borrowers can also roll in monthly payments of the mortgage until the property is livable (up to six months).	
Up-front FHA mortgage insurance premium	1.75% $ 4,221
Consultant initial architectural draft	$ 500
Charges for signing off on work draws	$ 250 ($50, up to five inspections)
Supplemental orgination fee (allowed on 203(k) loans by HUD – 1.5% of rehabilitation portion of loan)	$ 750
Closing cost (estimate)	$ 1,500
Total fees	$ 7,221
Loan-to-Value	
Purchase and rehabilitation costs	$241,250
Fees	$ 7,221
Total	$248,471
"As-improved" value	$250,000
Loan-to-Value	99.4%

Appendix B

203(k) Resources

203(k) Program Overview
www.hud.gov/offices/hsg/sfh/203k/203kmenu.cfm

Q&As on FHA 203(k) Program
http://www.hud.gov/offices/hsg/sfh/203k/faqs203k.cfm

203(k) Handbook
http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4240.4/index.cfm

Appendix C

Maximum FHA 203(k) Loan Limits[a]

FHA 203(k) maximum mortgage insurance limits are the same as those that apply to FHA 203(b).

There is a nationwide limit that applies without regard to the level of area median home prices, which is referred to as the "floor." This limit is set at 65 percent of the Freddie Mac (Federal Home Loan Mortgage Corporation) conforming loan limit ($417,000 for 2009) and is adjusted annually to reflect home price changes. For 2009 the floor limits for one-to-four family units are:

One-family unit	$271,050
Two-family unit	$347,000
Three-family unit	$419,400
Four-family unit	$521,250

Upward adjustments are made to these limits for higher-cost areas. Any area where the limits exceed the floor is treated as a high-cost area. High-cost limits are set at 115 percent of the median area home price up to a maximum cap of 175 percent of the Freddie Mac conforming loan limit. The high-cost limits are capped at the ceiling as follows:

One-family unit	$ 729,750
Two-family unit	$ 934,200
Three-family unit	$1,129,250
Four-family unit	$1,403,400

These limits are in place through December 31, 2009.

[a] Source: FHA Mortgagee Letter 2009-07.

Derek Hyra was the primary author of this report. Also contributing were Sharon Canavan, Hershel Lipow, William Reeves, Barry Wides, and Julie L. Williams. *Community Development Insights* reports differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the OCC.