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## **REHABILITATE A HOME WITH HUD'S 203(k)**

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### **U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT OFFICE OF THE ASSISTANT SECRETARY FOR HOUSING-FEDERAL HOUSING COMMISSIONER MAY 1994**

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**The Federal Housing Administration (FHA), which is part of the Department of Housing and Urban Development (HUD), administers various single family mortgage insurance programs. These programs operate through FHA approved lending institutions which submit applications to have the property appraised and have the buyer's credit approved. These lenders fund the mortgage loans which the Department insures. HUD does not make direct loans to help people buy homes.**

**The Section 203(k) program is the Department's primary program for the rehabilitation and repair of single family properties. As such, it is an important tool for community and neighborhood revitalization and for expanding homeownership opportunities. Since these are the primary goals of HUD, the Department believes that Section 203(k) is an important program and we intend to continue to strongly support the program and the lenders that participate in it.**

**Many lenders have successfully used the Section 203(k) program in partnership with state and local housing agencies and nonprofit organizations to rehabilitate properties. These lenders, along with state and local government agencies, have found ways to combine Section 203(k) with other financial resources, such as HUD's HOME and Community Development Block Grant Programs, to assist borrowers. Several state housing finance agencies have designed programs, specifically for use with Section 203(k) and some lenders have also used the expertise of local housing agencies and nonprofit organizations to help manage the rehabilitation processing.**

**The Department also believes that the Section 203(k) program is an excellent means for lenders to demonstrate their commitment to lending in lower income communities and to help meet their responsibilities under the Community Reinvestment Act (CRA). HUD is committed to increasing homeownership opportunities for families in these communities and Section 203(k) is an excellent product for use with CRA-type lending programs.**

**If you have questions about the 203(k) program or are interested in getting a 203(k) insured mortgage loan, we suggest that you get in touch with an FHA approved lender in your area. Names of the 203(k) approved lenders can be obtained from the local HUD Field Office in your area.**

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### ***Introduction:***

**Section 101 (c) (1) of the Housing and Community Development Amendments of 1978 (Public Law 95557) amends Section 203(k) of the National Housing Act (NHA). The objective of the revision is to enable HUD to promote and facilitate the restoration and preservation of the Nation's existing housing stock. The provisions of Section 203(k) are located in Chapter II of Title 24 of the Code of Federal Regulations under Section 203.50 and Sections 203.440 through 203.494. Program instructions are in HUD Handbook 4240.4.**

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### ***203(k) - How It Is Different***

**Most mortgage financing plans provide only permanent financing. That is, the lender will not usually close the loan and release the mortgage proceeds unless the condition and value of the property provide adequate loan security. When rehabilitation is involved, this means that a lender typically requires the improvements to be finished before a long-term mortgage is made.**

**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 relatively 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.**

**To minimize the risk to the mortgage lender, the mortgage loan (the maximum allowable amount) is eligible for endorsement by HUD as soon as the mortgage proceeds are disbursed and a rehabilitation escrow account is established. At this point the lender has a fully-insured mortgage loan.**

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### ***Eligible Property :***

**To be eligible, the property must be a one- to four-family dwelling that has been**

completed for at least one year. The number of units on the site must be acceptable according to the provisions of local zoning requirements. All newly constructed units must be attached to the existing dwelling. Condominium and Cooperative units are not eligible.

Homes that have been demolished, or will be razed as part of the rehabilitation work, are eligible provided the existing foundation system is not affected and will still be used. The complete foundation system must remain in place.

In addition to typical home rehabilitation projects, this program can be used to convert a one family dwelling to a two, three, or four-family dwelling. An existing multi-unit dwelling could be decreased to a one- to four-family unit.

An existing house on another site can be moved onto the mortgaged property; however, release of loan proceeds for the existing structure on the non-mortgaged property is not allowed until the new foundation has been properly inspected and the dwelling has been properly placed and secured to the new foundation.

A 203(k) mortgage may be originated on a "mixed use" residential property provided: (1) The property has no greater than 25 percent (for a one story building); 33 percent (for a three story building); and 49 percent (for a two story building) of its floor area used for commercial (storefront) purposes; (2) the commercial use will not affect the health and safety of the occupants of the residential property; and (3) the rehabilitation funds will only be used for the residential functions of the dwelling and areas used to access the residential part of the property.

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#### ***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 four 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.

For A and C above, the mortgage must be a first lien on the property and the loan proceeds (other than rehabilitation funds) may be available before the rehabilitation begins.

For B above, the mortgage must be a first lien on the property; however, loan proceeds for the moving of the house cannot be made available until the unit is attached to the new foundation.

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### *Eligible Improvements*

Mortgage proceeds must be used in part for rehabilitation and/or improvements to a property.

There is a minimum \$5000 requirement for the eligible improvements on the existing structure(s) on the property. Rehabilitation or improvements or improvements to a detached garage, a new detached garage, or the addition of an attached unit(s) (if allowed by the local zoning ordinances) can also be included in this first \$5000. Properties with separate detached units are acceptable, however, a newly constructed unit must be attached to an existing unit to be eligible under 203(k).

Any repair is acceptable in the first \$5000 requirement that may affect the health and safety of the occupants. Minor or cosmetic repairs by themselves cannot be included in the first \$5000, but may be added after the \$5000 threshold is reached.

Examples of eligible improvements are listed below. (This list is not all inclusive.)

- Structural alterations and reconstruction (e.g., repair or replacement of structural damage, chimney repair, additions to the structure, installation of an additional bath(s), skylights, finished attics and/or basements, repair of termite damage and the treatment against termites or other insect infestation, etc.)
- Changes for improved functions and modernization (e.g., remodeled bathrooms and kitchens, including permanently installed appliances, i.e., built-in range and/or oven, range hood, microwave, dishwasher).
- Elimination of health and safety hazards (including the resolution of defective paint surfaces or lead-based paint problems on homes built prior to 1978).
- Changes for aesthetic appeal and elimination of obsolescence (e.g., new exterior siding, adding a second story to the home, covered porch, stair railings, attached carport).
- Reconditioning or replacement of plumbing (including connecting to public water and/or sewer system), heating, air conditioning and electrical systems. Installation of new plumbing fixtures is acceptable, including interior whirlpool bathtubs.
- Installation of Well and/or Septic System. The well or septic system must be installed or repaired prior to beginning any other repairs to the property. A property less than 1/2 acre with a separate well or septic system is not acceptable; also, a property less than 1 acre

with

both a well and a septic system is unacceptable. Lots smaller than these sizes, usually have problems in the future; however, the local HUD Field Office can approve smaller lot size requirements where the local health authority can justify smaller lots. The installation of a

new well or the repair of an existing well (used for the primary water source to the property)

can be allowed provided there is adequate documentation to show there is reason to believe

the well will produce a sufficient amount of potable water for the occupants. (A well log of surrounding properties from the local health authority is acceptable

documentation.) Refer

to HUD Handbook 4910.1, Appendix K, for additional information.

- Roofing, gutters and downspouts.
- Flooring, filing and carpeting.
- Energy conservation improvements (e.g., new double pane windows, steel insulated exterior doors, insulation, solar domestic hot water systems, caulking and weather-stripping, etc.).
- Major landscape work and site improvement, patios, decks and terraces that improve the value of the property equal to the dollar amount spent on the improvements or required to preserve the property from erosion. The correction of grading and drainage problems is also acceptable. Tree removal is acceptable if the tree is a safety hazard to the property. Repair of existing walks and driveway is acceptable if it may affect the safety of the property. (Fencing, new walks and driveways, and general landscape work (i.e., trees, shrubs, seeding or sodding) cannot be in the first \$5000 requirement.)
- Improvements for accessibility to the Handicapped (e.g., remodeling kitchens and baths for wheelchair access, lowering kitchen cabinets, installing wider doors and exterior ramps, etc.).

When basic improvements are involved, the following costs can be included in addition to the minimum \$5000 requirement:

- New free standing range, refrigerator, washer and dryer, trash compactor and other appurtenances (Used appliances are not eligible).
- Interior and exterior painting.
- The repair of a swimming pool, not to exceed \$1,500. Repair costs exceeding the \$1,500 limit must be paid into the contingency reserve fund by the borrower. The installation of a new swimming pool is not allowed.

Luxury items and improvements that do not become a permanent part of the real property are not eligible as a cost of rehabilitation. The items listed below (not limited to this list) are not acceptable under the 203(k) program, including the repair of any of the following:

- Barbecue pit; bathhouse; dumbwaiter; exterior hot tub; sauna, spa and whirlpool bath;
- outdoor fireplace or hearth; photo mural; installation of a new swimming pool; gazebo; television antenna; satellite dish; tennis court; tree surgery. Additions or alterations to provide for commercial use are not eligible.

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### **Required Improvements**

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

- Cost Effective Energy Conservation Standards
  - Addition to Existing Structure. New construction must conform with local codes and HUD Minimum Property Standards in 24 CFR 200.926d.
  - Rehabilitation of Existing Structure. To improve the thermal efficiency of the dwelling, the following are required:
    - Weatherstrip all doors and windows to reduce infiltration of air when existing weatherstripping is inadequate or nonexistent.
    - Caulk or seal all openings, cracks or joints in the building envelope to reduce air infiltration.
    - Insulate all openings in exterior walls where the cavity has been exposed as a result of the rehabilitation. Insulate ceiling areas where necessary.
    - Adequately ventilate attic and crawl space areas.
  - Replacement Systems
    - Heating, ventilating, and air conditioning system supply and return pipes and ducts must be insulated whenever they run through unconditioned spaces.
    - 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.
- 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.

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### **Required Appraisals**

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

- **As-Is Value**

**The property is appraised in its present condition. It reflects those benefits to be derived from legal use of the property. Repair requirements are not included in this as-is value appraisal. Include closing costs reflecting the as-is value of the property.**

- **Value After Rehabilitation**

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

**The lender may determine that an as-is appraisal is not feasible or necessary. The lender may use the contract sales price (on a purchase transaction) or the existing debt on the property (on a refinance transaction) as the as-is value when it is clear to the lender that this amount does not exceed a reasonable estimate of value. On a refinance transaction, when a large amount of existing debt (i.e., first and secondary mortgages) suggests to the lender that the borrower has little or no equity in the property, the lender should always obtain an as-is appraisal on which to base the estimate of as-is value.**

**For a HUD-owned property an as-is appraisal is not required and a DE lender may request the HUD Field Office to release the outstanding HUD Property Disposition appraisal on the property to the lender to establish the maximum mortgage for the property. The HUD appraisal will be considered acceptable for use by the lender if:**

- **it is not over one year old prior to bid acceptance from HUD; and**
- **the sales contract price plus the cost of rehabilitation does not exceed 110 percent of the "As-Repaired Value" shown on the HUD appraisal.**

**If the HUD appraisal is insufficient, the DE Lender may order another appraisal to assure the market value of the property will be adequate to make the purchase of the property feasible.**

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***Purchase of HUD-Owned Properties***

**Homebuyers (including investors) who purchase HUD-owned property can refinance the property using 203(k) within six (6) months of purchase, the same as if the buyer purchased**

the property with a 203(k) insured loan to begin with. Evidence of interim financing is not required; the mortgage calculations will be done the same as a purchase transaction. Cash back will be allowed to the borrower in this situation. A copy of the HUD Sales Contract and the HUD-1 Settlement Statement must be submitted to verify the accepted bid price (as-is value) of the property and the closing date.

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### ***Architectural Exhibits***

The improvements must comply with HUD's Minimum Property Standards (24 CFR 200.926d and/or HUD Handbook 4905.1) 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.

- **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 detail. Include finished grade elevations at the property comers and building comers.  
Show the required flood elevation.**
- **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.)**
- **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:**



- there are no rodents, dryrot, termites and other infestation;
- there are no defects that will affect the health and safety of the occupants;
- the adequacy of the existing structural, heating, plumbing, electrical and roofing systems; and
- the upgrading of thermal protection (where necessary).

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### **Insurance of Advances**

**This refers to insurance of the 20300 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.**

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### **Rehabilitation Escrow Account**

**When the loan is closed, the proceeds designated for the rehabilitation or improvement, including the contingency reserve, are to be placed in an interesting 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).**

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### **Inspections**

**Performed by HUD-approved fee inspectors assigned by the HUD Field Office 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.

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### ***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.

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### ***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 than \$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, Form HUD 92577, must be submitted with the applicable cost estimates. However, the change can only be accepted when the lender determines:

- It is unlikely that any deficiency that may affect the health and safety of the property will be discovered; and
- the mortgage will not exceed 95% (owner-occupant) or 85% (investor) of the appraised value of the property. If the mortgage exceeds 95% or 85% of the appraised value, 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.**

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### ***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 is issued or when occupancy of the property occurs (whichever is first), must be applied to the mortgage principal.**

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### **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.**

- **Maximum Mortgage Calculation.**

**The value is defined as the lesser of:**

- **The as-is value of the property before rehabilitation plus the cost of**

- rehabilitation;
- or
- o 110 percent of the expected market value of the property upon completion of the work.
- **Principal Residence (Owner-Occupant).**  
The maximum mortgage amount is to be based upon 97/95 percent of the HUD estimate of value in 1) or 2) above.
- **Investment Property (Non-Occupant Mortgagor or Builder/Rehabber).**  
The maximum mortgage amount will be based on 85 percent of the HUD estimate of value in 1) or 2) above.
- **Escrow Commitment Procedure.**  
A builder/ rehabber who purchases an investment property but intends to sell the rehabilitated property to a mortgagor acceptable to HUD, may qualify for a mortgage based on the loan-to-value ratio and maximum dollar amount limitations prescribed under Section 203(b) for a principal residence, provided the dollar difference between the maximum mortgage amount and the mortgage amount available to an investor is placed in escrow with the lender.

To allow for maximum owner-occupant financing when the loan is assumed (by an owner-occupant acceptable to HUD) and to avoid the extra cost for a new mortgage, the downpayment requirement for the investor may be based on the market value of the property after rehabilitation. The difference between the downpayment requirements for an owner occupant and an investor would be retained in an escrow account.

If the property is not sold prior to the 18th amortization payment of the mortgage, the entire escrow amount must be applied as a principal balance and reduce the mortgage amount to an amount available for an investment property.

A First Time Homebuyer (FTH) can assume the mortgage for no downpayment. An owneroccupant who is not a FTH must provide a downpayment into the deal. Another investor could assume the loan by putting a 15% downpayment into the deal. If the resale price is less than the appraised value of the property, the mortgage amount must be reduced so that the purchaser maintains a minimum downpayment based on the acquisition price. If the resale price is greater than the appraised value, the purchaser must make a larger downpayment.

**Example: Assume a Builder/Rehabber can purchase a property for \$50,000, and the cost of rehabilitation will be \$20,000. The Builder/ Rehabber will have to put a minimum 15% downpayment (\$10,500) on the acquisition cost of \$70,000 (\$50,000 + \$20,000). If the after-rehab appraisal shows the market value of the property will be \$100,000 after the completion of the rehabilitation, then the mortgage for an owner-occupant who will assume the loan will be \$95,500. The Builder/Rehabber will apply \$10,500 to the escrow account and the loan proceeds will provide \$25,500 (95,500 \$70,000). When the loan is assumed by a qualified borrower, the total amount of \$36,000 in the escrow commitment account will be released to the Builder/Rehabber. A First Time Homebuyer could assume this mortgage for no downpayment.**

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### ***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 architectural/engineering fee.**

**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.**

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### ***Exemption of the Market Value Limitation***

**The 203(k) Regulations allow for a waiver of the market value limitation. Such requests must be forwarded to the Assistant Secretary of Housing-Federal Housing Commissioner at the HUD Headquarters. Requests must include documentation that the following conditions are present:**

- **The property is located within an area which is subject to a community sponsored program of concentrated redevelopment or revitalization.**
- **The market value loan limitation prevents the use of the program to accomplish rehabilitation in the subject area.**
- **The interests of the borrower and the Secretary of HUD are adequately protected.**

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### ***Solar Energy Increase***

The mortgage is eligible for an increase of up to 20 percent in the maximum insurable mortgage amount if such an increase is necessary for the installation of solar energy equipment. The solar energy system's contribution to value will be limited by its replacement cost or by its effect on the value of the dwelling.

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### ***Seven Unit Limitation***

HUD regulations and policies state that an investor should not be allowed to rapidly accumulate FHA insured properties that clearly and collectively constitute a multifamily project. In general, a borrower may not have an interest in more than seven units in the same subdivision or contiguous area. For 203(k) purposes, HUD defines a contiguous area as "within a two block radius."

The local HUD Field Office can determine that units in a neighborhood are not subject to the seven unit limit described above if:

- the neighborhood has been targeted by a State or local government for redevelopment or revitalization; and
- the State or local government has submitted a plan to HUD that defines the area, extent and type of commitment to redevelop the area.

A restriction may still be imposed within a redevelopment area (or sub-area) in order to prevent undesirable concentrations of units under a single (or group) ownership. HUD will determine that the seven unit limit is inapplicable only if:

- the investor will own no more than 10 percent of the housing units (regardless of financing type) in the designated redevelopment area or sub-area; and
- investor has no more than eight units on adjacent lots.

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### ***Interest Rate and Discount Points***

These are not regulated and are negotiable between the borrower and the lender. The amortization of the loan will be for 30 years; however, provisions of the Section 203(k) mortgage (described in Section 203.21 of the Regulations) are the same as prescribed under Section 203(b).

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### ***Maximum Charges and Fees***

The statutory requirements and administrative policies of Section 203(k) result in

**deviations**

from the maximum amount of charges and fees permitted under Section 203(b).

- **Supplemental Origination Fee**

When the Section 203(k) mortgage involves insurance of advances, the lender may collect from the mortgagor a supplemental origination fee. This fee is calculated as one and one-half percent (1 1/2%) of the portion of the mortgage allocated to the rehabilitation or \$350, whichever is greater. This supplemental origination fee is collected in addition to the one percent origination fee on the total mortgage amount.

- **Independent Consultant Fee**

A borrower can have an independent consultant prepare the required architectural exhibits. A borrower can also use a contractor to prepare the construction exhibits or prepare the exhibits themselves. The use of a consultant is not required; however, the borrower should consider using this service in order to expedite the processing of the 203(k) loan. When a consultant is used, HUD does not warrant the competence of the consultant or the quality of the work the consultant may perform for the borrower.

The consultant must enter into a written agreement with the borrower that completely explains what services the consultant will perform for the borrower and the fee charged.

The fee charged by the consultant can be included in the mortgage.

A fee of \$400 is acceptable for a property with repairs less than \$7,500; \$500 for repairs between \$7,501 and \$15,000; \$600 for repairs between \$15,001 and \$30,000; and \$700 for repairs greater than \$30,000. For this fee, the consultant would inspect the property and provide all the required architectural exhibits. State licensed Architect or Engineer fees are not restricted by this fee schedule. The architect and engineer fees must be customary and reasonable for the type of project.)

- **Plan Review Fee**

Prior to the appraisal, a HUD accepted plan reviewer (or fee consultant) must visit the site to ensure compliance with program requirements. The utilities must be on for this site review to take place. The fee is as follows and may not be changed without HUD Headquarters approval:

- Initial review prior to appraisal:

**Cost of Repairs**

**Fee**

\$15,001 ; = \$30,001

\$200.00

- **Additional unit review (two to four units with same case number)- \$50.00/unit.**
- **Additional review (reinspection of the same unit)-\$50.00.**
- **When travel distance exceeds 30 miles round trip from the reviewer's place of business, a mileage charge (established by HUD Field Office) may be applied to the above charges, including toll road and other charges where applicable.**
- **Appraisal Fee**  
**To process a Section 203(k) mortgage, two appraisals can be performed:**
  - **As-is value of the property; and**
  - **Estimated market value of the property assuming completion of the rehabilitation.**

**The maximum fee which a lender may collect for these two appraisals is one and one-half times the amount permitted for a Section 203(b) proposed construction appraisal, as established by the HUD Field Office. If only one appraisal is done, the fee will be the same as a proposed construction appraisal.**

- **Inspection Fee (during the rehabilitation construction period)**  
**Established by the local HUD Field Office.**
  - **Fees for a maximum of five draw inspections will be allowed for inclusion in the cost of rehabilitation. If all inspections are not required, remaining funds will be applied to the principal after the Final Release Notice is issued.**
  - **If additional inspections are required by the lender to ensure satisfactory compliance with exhibits, the borrower or contractor will be responsible for payment; however, the lender has ultimate responsibility.**
- **Title Update Fee**  
**To protect the validity of the mortgage position from mechanics liens on the property, reasonable fees charged by a title company may be included as an allowable cost of rehabilitation. When the mortgage position is protected and is not in jeopardy, this fee may not apply. Borrowers may wish to obtain lien protection, but the fees must**

**be paid by the borrower where such lien protection is not required to ensure the validity of the security instrument.**

**The allowable fee should not exceed \$50.00 per draw release. If all draw inspections**



are not made, monies left in escrow must be applied to reduce the mortgage balance.

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### ***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, the plan reviewer, appraiser and the inspector.

- **Homebuyer Locates the Property**
- **Preliminary Feasibility Analysis**  
After the property is located, the homebuyer and their realtor should make a marketability analysis prior to signing the sales contract. The following should be determined:
  - The extent of the rehabilitation work required;
  - Rough cost estimate of the work; and
  - 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.

- **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.
- **Homebuyer Selects Mortgage Lender**  
Call HUD Field Office for list of lenders.
- **Homebuyer Prepares Work Write-up and Cost Estimate**  
A consultant can help the buyer prepare the exhibits to speed up the loan process. If a plan reviewer is the consultant, item G can be skipped and the exhibits can go directly to the appraisal stage.
- **Lender Requests HUD Case Number**  
Upon acceptance of the architectural exhibits, the lender requests the assignment of a HUD case number, the plan reviewer, appraiser, and the inspector.
- **Plan Reviewer Visits Property**  
The homebuyer and contractor (where applicable) meet with the plan reviewer to ensure that the architectural exhibits are acceptable and that all program

requirements  
have been properly shown on the exhibits.

- **Appraiser Performs the Appraisal**  
**Lender Reviews the Application.** The appraisal is reviewed to determine the maximum insurable mortgage amount for the property.

**Issuance of Conditional Commitment/Statement of Appraised Value.** This is issued by the Lender and establishes the maximum insurable mortgage amount for the property.

- **Lender Prepares Firm Commitment Application**  
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.
- **Lender Issues Firm Commitment**  
If the application is found acceptable, 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.

- **Mortgage Insurance Endorsement**  
Following loan closing, the lender submits copies of the mortgage documents to the HUD office for mortgage insurance endorsement. HUD reviews the submission and, if found acceptable, issues a Mortgage Insurance Certificate to the lender.
- **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. (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.

- **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 is unused contingency funds or mortgage payment reserves in the Account, the lender must apply the funds to prepay the mortgage principal.

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### Questions and Answers

#### Section 203(k) Rehabilitation Mortgage Insurance

*Is there a secondary mortgage market for Section 203(k) mortgage loans?*

**Yes.** The Government National Mortgage Association (GNMA) permits the Section 203(k) mortgage to be placed in both GNMA I and II pools with Section 203(b) mortgages. GNMA accepts the 203(k) mortgage once it has been endorsed by HUD. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) will also purchase a Section 203(k) first mortgage.

*Is the Section 203(k) program restricted to single-family dwellings?*

**No.** The program can be used for one to four unit dwellings. Maximum mortgage limitations are the same as for properties under Section 203(b).

*Can Section 203(k) be used to improve a condominium unit?*

**No.**

*Can Section 203(k) be used to convert a one family dwelling to a two, three, or four-family dwelling (or vice versa)?*

**Yes.**

*Can Section 203(k) be used to move an existing house onto another site?*

- **Yes. However, release of loan proceeds for the existing structure on the non-mortgaged property is not allowed until the new foundation has been properly inspected and the dwelling has been properly placed and secured to the new foundation.**
- **At closing, funds would be released to purchase the site and the rest of the mortgage proceeds would be placed in the Rehabilitation Escrow Account. The Borrower would have the site prepared to accept the dwelling. The first release would be based on the improvements made to the site, including the installation of the existing structure on the new foundation.**

*What is the minimum amount of rehabilitation required for a Section 203(k) mortgage?*

- **There is a minimum \$5,000 requirement for the eligible improvements on the existing structure on the property. Minor or cosmetic repairs by themselves are unacceptable; however, they may be added to the minimum requirement.**

*What eligible improvements are acceptable under the \$5,000 minimum requirement?*

- **Structural alterations and reconstruction (e.g., repair or replacement of structural damage, chimney repair, additions to the structure, installation of an additional bath(s), skylights, finished attics and/or basements, repair of termite damage and the treatment against termites or other insect infestation, etc.)**
- **Changes for improved functions and modernization (e.g., remodeled bathrooms and kitchens, including permanently installed appliances, i.e., built-in range and/or oven, range hood, microwave, dishwasher).**
- **Elimination of health and safety hazards (including the resolution of defective paint surfaces or lead-based paint problems on homes built prior to 1978).**
- **Changes for aesthetic appeal and elimination of obsolescence (e.g., new exterior siding, adding a second story to the home, covered porch, stair railings, attached carport).**
- **Reconditioning or replacement of plumbing (including connecting to public water and/or sewer system), heating, air conditioning and electrical systems. Installation of new plumbing fixtures is acceptable, including interior whirlpool bathtubs.**
- **Installation of Well and/or Septic System. The well or septic system must be installed or repaired prior to beginning any other repairs to the property. A property less than**

**1/2 acre with a separate well or septic system is not acceptable; also, a property less than 1 acre with both a well and a septic system is unacceptable. Lots smaller than these sizes, usually have problems in the future; however, the local HUD Field Office can approve smaller lot size requirements where the local health authority can justify smaller lots.**

**The installation of a new well or the repair of an existing well (used for the primary water source to the property) can be allowed provided there is adequate documentation to show there is reason to believe the well will produce a sufficient amount of potable water for the occupants. (A well log of surrounding properties from the local health authority is acceptable documentation.) Refer to HUD Handbook 4910.1, Appendix K, for additional information.**

- **Roofing, gutters and downspouts.**
- **Flooring, tiling and carpeting.**
- **Energy conservation improvements (e.g., new double pane windows, steel insulated exterior doors, insulation, solar domestic hot water systems, caulking and weatherstripping, etc.).**
- **Major landscape work and site improvement, patios, decks and terraces that improve the value of the property equal to the dollar amount spent on the improvements or required to preserve the property from erosion. The correction of grading and drainage problems is also acceptable. Tree removal is acceptable if the tree is a safety hazard to the property. Repair of existing walks and driveway is acceptable if it may affect the safety of the property. (Fencing, new walks and driveways, and general landscape work (i.e., trees, shrubs, seeding or sodding) cannot be in the first \$5000 requirement.)**
- **Improvements for accessibility to the Handicapped (e.g., remodeling kitchens and baths for wheelchair access, lowering kitchen cabinets, installing wider doors and exterior ramps, etc.).**
- **Related fixtures such as new cooking ranges, refrigerators, and other appurtenances, as well as general painting are also eligible; however, it must be in addition to the \$5,000 requirement.**

***Can a detached garage or another dwelling be placed on the mortgaged property?***

**Yes. However, a new unit must be attached to the existing dwelling, and must comply with HUD's Minimum Property Standards in 24 CFR 200.926d and all local codes and ordinances.**

*Is there a time period on the rehabilitation construction period?*

**Yes. The Rehabilitation Loan Agreement contains three provisions concerning the timeliness of the work. The work must begin within 30 days of execution of the Agreement. The work must not cease prior to completion for more than 30 consecutive days. The work is to be completed within the time period shown in the Agreement (not to exceed 6 months); the lender should not allow a time period longer than that required to complete the work.**

*What happens if the Borrower fails to perform under the terms of the Agreement?*

**The lender may refuse to make further releases from the Rehabilitation Escrow Account.**

**The funds remaining in the Account can be applied to reduce the mortgage principal. Also, the lender has the option to call the mortgage loan due and payable.**

*Does the rehabilitation construction have to comply with HUD's Minimum Property Standards?*

**Yes. The improvements must comply with HUD's Minimum Property Standards (24 CFR 200.926d and/or HUD Handbook 4905.1) and all local codes and ordinances.**

*Can Section 203(k) be processed under the Direct Endorsement program?*

**Yes. Direct Endorsement Lenders are required to attend special training prior to processing 203(k) loans and they must submit test cases as determined by the local office.**

*Does HUD always require a contingency reserve to cover unexpected cost increases?*

**Typically, yes. On properties older than 30 years and over \$7,500 in rehabilitation costs, the cost estimate must include a contingency reserve. The reserve must be 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 utilities were not turned on for inspection, a minimum fifteen (15) percent is required.**

*How many draw releases can be scheduled during the rehabilitation period?*

**As many as five releases (four plus a final) can be scheduled. The number of releases is normally dictated by the cash-flow requirements of the contractor. An inspection is always required with a scheduled release; however, inspections may be scheduled more often than releases if necessary to ensure compliance with the architectural exhibits, HUD's Minimum Property Standards and all local codes and ordinances. If the cost of rehabilitation exceeds \$10,000, then additional draw inspections may be authorized under certain circumstances.**

*Can the architectural exhibits, including the cost estimate, be modified after the mortgage loan is closed?*

**Yes. The changes must be approved by HUD or a DE lender prior to beginning the work.**

**If the change affects the health, safety or necessity of the dwelling, the contingency reserve**

**can be used to pay for the change. However, if the health, safety or necessity of the dwelling**

**is not affected and an increase in cost occurs, the Borrower must apply monies into the contingency reserve fund to pay for the change. Should the change result in a reduced cost**

**of rehabilitation, the difference will be placed in the contingency reserve fund; if unused, it**

**will be applied as a mortgage prepayment after completion of construction.**

*What happens if the cost of the rehabilitation increases during the rehabilitation period?*

*Can*

*the 203(k) mortgage amount be increased to cover the additional expenses?*

**No. This emphasizes the importance of carefully selecting a contractor who will accurately estimate the cost of the improvements and satisfactorily complete the rehabilitation at or below the estimate.**

*How long will it take after the sales contract is signed to go to closing?*

**If the cost estimates are completed within two weeks of signing the sales contract, the loan**

**should close within 60 to 90 days, assuming there are no title problems and, of course, your borrower is qualified.**

*Can a Section 203(k) mortgage be an Adjustable Rate Mortgage?*

**Yes. An Adjustable Rate Mortgage is available to an owner-occupant only. Investors**

**are  
not eligible for an ARM.**

***Does a Direct Endorsement lender who is approved for the 203(k) program need to be approved in another HUD office?***

**No; however, the lender needs to submit their approval to the other HUD office where they wish to originate 203(k) loans. Preclosing review in the new HUD office will not be necessary.**

***Can a DE lender sponsor a correspondent lender to originate 203(k) loans?***

**Yes. The correspondent lender can even use the DE sponsor's staff appraisers, inspectors and plan reviewer/consultants for processing.**

***Can an investor use the 203(k) program?***

**Yes. Investors must have a 15% downpayment and can purchase (or refinance) and rehabilitate properties for rental purposes or sell the property (and get their profit using the Escrow Commitment Procedure) to a qualified Homebuyer (who assumes the loan).**

***Can a local government agency or a nonprofit organization use the 203(k) program?***

**Yes. The same qualification requirements will be used as for an owner-occupant of the property.**

***Can mortgage payments (PITI) be included in the mortgage?***

**Yes. Up to 6 months of payments may be included in the mortgage if the property is not occupied during the rehab period.**

***Can a six (or more) unit building be done using the 203(k) program?***

**No. However, the building could be renovated and reduced to a four unit building.**

***Can a dwelling be converted to provide for Handicap access?***

**Yes. A dwelling can be remodeled to improve the kitchen and bath to accommodate a wheelchair access. Wider doors and handicap ramps can also be included in the cost of rehabilitation.**

***Is a contractor required to do the work?***



**No. However, if the borrower wants to do any work or be the general contractor, they must be qualified to do the work, and do it in a timely and workmanlike manner. It is very important that the work be done in a time frame that will assure the completion of the work that will be agreed upon in the Rehabilitation Loan Agreement (signed at closing). A borrower doing their own work can only be paid for the cost of the materials. Monies saved can be allocated to cost overruns or additional improvements.**

*If the borrower does the work, how is the cost for work estimated?*

**The cost estimate must be the same as if a contractor is doing the work, in case the borrower cannot (for some reason) complete the work.**

*Can cost savings on the rehabilitation be given back to the borrower?*

**No. However, the savings can be transferred to cost overruns in other work items or can be used to make additional improvements to the property. If the cost savings are not used, the money must be applied to the mortgage principal, but the mortgage payments will remain the same, because the loan has already closed. To use the cost savings, it will be necessary for a Change Order to be completed and approved by the lender.**

*Can any rehabilitation money be paid upfront to offset the startup costs for the contractor?*

**No. However, an exception can be allowed for kitchen and bath cabinetry, or floor covering, where a contract is established with the supplier and an order is placed with the manufacturer for delivery at a later date.**

*Is there anyone available who can prepare the work writeup and cost estimates?*

**Yes. HUD allows fee inspectors to be an independent consultant with the borrower. This is a time saver, because it can be completed in about two weeks. After this step is completed, closing should occur within 60 to 90 days.**

*Can the borrower do their own work writeup and cost estimate?*

**Yes. However, it will take them between three to six months to complete. This slows down the process and will save only about \$200, but waste a lot of valuable time. Hiring an independent consultant will help the closing occur within 60 to 90 days from completion**

of the work writeup.

*How can an investor purchase, rehab and sell a property at a profit using the 203(k) program?*

**Use the Escrow Commitment Procedure! This allows for good profits when the property is purchased at a good price, rehabilitated and sold at the after-improved value to an assuming borrower. A First Time Homebuyer can assume this type of loan for no downpayment.**

*What is the definition of a First Time Homebuyer?*

**A single person or an individual and his or her spouse who have not owned a home (as a tenant in common or as a joint tenant by the entirety) during the three years immediately preceding the date of application for the 203(k) loan. Any individual who is legally separated or divorced cannot be excluded from consideration, because the three year waiting period does not apply, provided the individual no longer has an interest in the home.**

*Is there a limitation on how many properties a person or organization can have in any area of the community?*

**Yes. A borrower can have not more than seven (7) units within a two block radius of the property they want to purchase. However, if the property is in a local community area that has been designated for redevelopment or revitalization, then the HUD office can waive this seven unit limitation.**

*Can nonresidential (storefront) property be eligible for a 203(k) insured loan?*

**Yes. Mixed use residential property is acceptable provided the property has no greater than 25% (for a one story building); 33% (for a three story building); and 49% (for a two story building) of its floor area used for commercial (storefront) purposes. The rehab funds can only be used for the residential functions of the dwelling and areas used to access the residential part of the property.**

*Is only one appraisal required to establish the "after-rehab" value of the property?*

**Basically, yes, provided the lender can be assured that the contract sales price is reasonable or the existing debt on the property is low enough to assure a good equity position by the homeowner. On a HUD-owned property, the lender can use HUD's appraisal for the after-**

rehab value.

*Can HUD-owned properties be purchased using the 203(k) loan?*

**Yes. However, the property must be advertised that it is eligible for financing with a 203(k) loan. If the HUD-owned property is purchased with other funds, a 203(k) loan can be made after the property is in the buyers name. In this case, cash back will be allowed to the borrower for a period of six months from purchasing the HUD-owned property.**

*Is the borrower required to enter into a contractual agreement with the general contractor who will do the work on the property?*

**No. However, it is strongly suggested that the lender protect their interests to assure no liens are placed on the property.**

*Can an Energy Efficient Mortgage (EEM) be allowed using the 203(k) program?*

**Yes. However, it is only allowed under a pilot program in the States of Alaska, Arkansas, California, Vermont and Virginia.**

**U.S. Department of Housing and Urban Development  
7th & D Street S.W.  
Washington, D.C. 20410-3000**

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