

## FHA 203(k) Mortgage Insurance Program: Helping Banks and Borrowers Revitalize Homes and Neighborhoods

### **Abstract**

This *Insights* report focuses on the Federal Housing Administration's (FHA) 203(k) Rehabilitation Mortgage Insurance, an important financial tool that enables borrowers to purchase and rehabilitate properties.<sup>1</sup> The 203(k) loan program provides government-backed insurance for mortgages that combine or refinance property acquisition and rehabilitation loans. By making 203(k) loans, banks can develop new business, mitigate risk, enhance profitability, and meet certain regulatory requirements, as well as assist in the revitalization and stabilization of neighborhoods by rehabilitating homes that might otherwise become or remain vacant. The primary purpose of this report is to advise banks of the potential benefits and risks of the 203(k) program. The secondary purpose is 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 presented in this report was obtained from a variety of sources, including FHA policies, and interviews with bankers 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 the addresses of Web sites with additional information on the 203(k) program.

### **I. What Is the FHA 203(k) Rehabilitation Mortgage Insurance Program?**

The FHA is part of the U.S. Department of Housing and Urban Development (HUD). The FHA 203(k) loan program helps HUD fulfill its goal of strengthening the housing market and building sustainable communities. Congress established the FHA 203(k) program in 1978.<sup>2</sup>

<sup>1</sup> In this *Insights* report, the 203(k) Rehabilitation Mortgage Insurance program is referred to as the 203(k) loan program or simply as the 203(k) program.

<sup>2</sup> See 12 USC 1709(k) at [www.gpo.gov/fdsys/granule/USCODE-2011-title12/USCODE-2011-title12-chap13-subchapII-sec1709/content-detail.html](http://www.gpo.gov/fdsys/granule/USCODE-2011-title12/USCODE-2011-title12-chap13-subchapII-sec1709/content-detail.html) and 24 CFR 203.50 at [www.accessdata.fda.gov/scripts/cdrh/cfdocs/cfcfr/CFRSearch.cfm?fr=203.50](http://www.accessdata.fda.gov/scripts/cdrh/cfdocs/cfcfr/CFRSearch.cfm?fr=203.50).

The mission of the 203(k) loan program is to help borrowers obtain mortgages to finance the acquisition and rehabilitation of single-family properties with one loan.<sup>3</sup> The 203(k) loan program provides government-backed insurance for mortgages made by FHA-approved lenders, thereby minimizing construction-period risks.

Without the availability of 203(k) loans, financing purchases and rehabilitation of single-family homes requiring repairs can be costly, time-consuming, and complicated. Typically, a home buyer wishing to purchase a property requiring repairs must obtain three separate financings: a short-term purchase loan, a short-term loan to cover rehabilitation costs, and a long-term mortgage to pay off the short-term purchase and rehabilitation loans.<sup>4</sup> The 203(k) program simplifies the financing process by allowing a borrower to obtain one federally insured mortgage to cover property acquisition and rehabilitation costs.

In addition, the 203(k) loans may be used in combination with other government resources to rehabilitate foreclosed and vacant homes. HUD's Home Investment Partnerships (HOME) program and the Community Development Block Grant (CDBG) program may help lenders reduce risks through a variety of approaches.<sup>5</sup> For example, soft-cost funding from the HOME program or the CDBG program can be used for down payments, credit counseling, or additional rehabilitation costs.

Additionally, Congress authorized nearly \$7 billion in funding for the Neighborhood Stabilization Program (NSP) under the Housing and Economic Recovery Act of 2008. The funds are for neighborhood stabilization activities, including loans to help borrowers purchase and rehabilitate foreclosed properties.<sup>6</sup> These resources, together with 203(k) loans, are helping to revitalize areas negatively affected by the recession and the foreclosure crisis.

As figure 1 illustrates, the total number of 203(k) loans rose from 2005 to 2012, reaching 21,391 in 2012. The upward trend in 203(k) originations mirrors a similar increase in the total number of FHA loans made during the period. Meanwhile, as conventional lenders tightened underwriting standards, 203(k) loans helped to fill the void because they are federally insured and have lower down payment requirements and broader underwriting guidelines. The dollar volume of 203(k) loan activity in 2012 was estimated at nearly \$1.7 billion.<sup>7</sup>

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<sup>3</sup> The 203(k) program allows properties with up to four dwelling units to be financed; however, the properties 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. See FHA Mortgage Letter 96-59, October 29, 1996, at [http://portal.hud.gov/hudportal/documents/huddoc?id=DOC\\_19748.txt](http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_19748.txt).

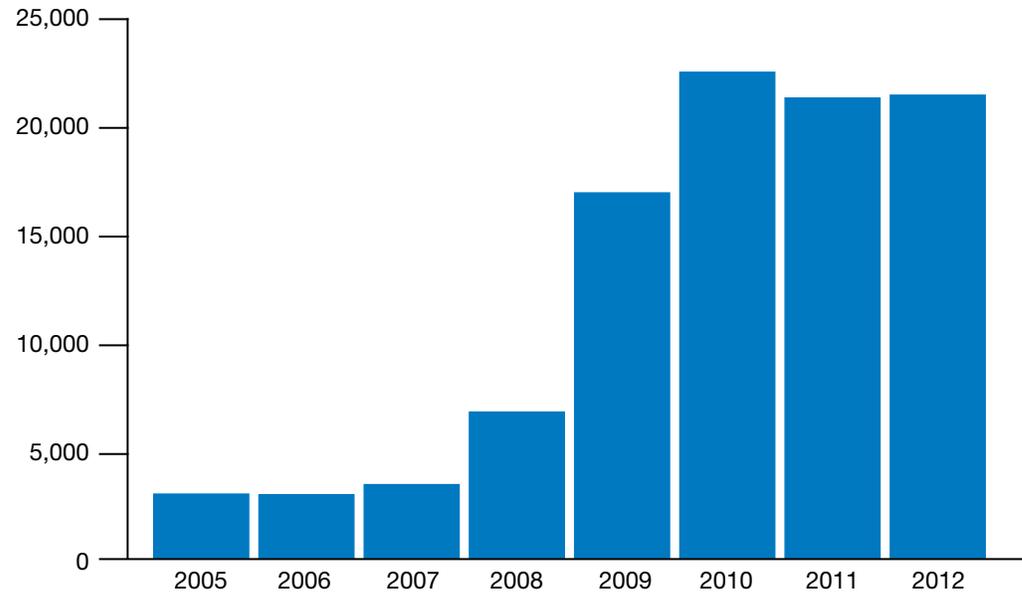
<sup>4</sup> *Homeownership: Problems Persist with HUD's 203(k) Home Rehabilitation Loan Program*, U.S. Government Accountability Office (GAO), report number GAO/RCED-99-124, Washington, D.C., 1999, at [www.gao.gov/products/RCED-99-124](http://www.gao.gov/products/RCED-99-124).

<sup>5</sup> 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 "Rehab a Home w/HUD's 203(k)," at [www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm](http://www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm).

<sup>6</sup> The NSP was authorized by the Housing and Economic Recovery Act of 2008 (Public Law 110-289), which provided \$3.92 billion in CDBG funds for state and local efforts to acquire and redevelop foreclosed properties. The American Recovery and Reinvestment Act of 2009 (Public Law 111-5) authorized \$2 billion in additional NSP funding distributed through competitive grants. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Public Law 111-203) provided an additional \$1 billion for the NSP. Under the NSP, entities receiving grants can use the funds to purchase and rehabilitate foreclosed or abandoned properties. See "Community Response to the Foreclosure Crisis: Thoughts on Local Interventions," Dan Immergluck, OCC Community Affairs Discussion Paper No. 01-08, Federal Reserve Bank of Atlanta, 2008 at [www.frbatlanta.org/filelegacydocs/dp\\_0108.pdf](http://www.frbatlanta.org/filelegacydocs/dp_0108.pdf).

<sup>7</sup> FHA data as of October 2012.

**Figure 1: Total FHA 203(k) Loans Originated by Lenders, 2005 to 2012**



Source: FHA

## **II. Why Is the FHA 203(k) Program Beneficial to Banks?**

As of September 2012, there were nearly 1.5 million foreclosed homes nationwide.<sup>8</sup> Many of these foreclosed homes remain vacant and in need of significant repairs. Lenders suggest that in certain housing markets 203(k) loans are among the few loans available to borrowers wanting to purchase and rehabilitate these foreclosed properties, particularly if borrowers are unable to provide down payments of 20 percent.

Federal policy is providing new opportunities to use FHA loans in high-cost areas. The American Recovery and Reinvestment Act of 2009 (ARRA) substantially raised the conforming loan limits for FHA loans in high-cost areas to \$729,750, thereby making more properties and borrowers eligible for 203(k) loans in high-cost markets.<sup>9</sup> Also, NSP funds can be used in conjunction with the 203(k) loans. For example, government entities and nonprofit organizations can use their NSP allocation to acquire foreclosed properties and then rehabilitate the properties with 203(k) financing secured from FHA-approved lenders.

Banks concerned about maintaining the appraised value of assets pledged as loan collateral in their residential portfolios may find it advantageous to finance the rehabilitation of blighted or vacant foreclosed properties in communities where they have significant mortgage investments. Research suggests that each foreclosed property in a low- or moderate-income census tract reduces the value of each nearby property by

<sup>8</sup> See RealtyTrac at [www.realtytrac.com/TrendCenter/default.aspx](http://www.realtytrac.com/TrendCenter/default.aspx).

<sup>9</sup> ARRA temporarily raised the conforming mortgage limits for FHA loans in high-cost areas to \$729,750 and set the national FHA conforming mortgage limit at \$417,000. Congress, however, sets conforming loan limits annually. See [www.recovery.gov/about/pages/the\\_act.aspx](http://www.recovery.gov/about/pages/the_act.aspx).

approximately \$1,600.<sup>10</sup> Banks making 203(k) loans and working in partnership with government agencies and nonprofit housing developers may help maintain residential collateral values, while also helping to stabilize neighborhoods.<sup>11</sup>

### New Business Development Opportunities

The 203(k) program offers lenders opportunities to serve new borrowers and expand their customer bases. The 203(k) program also facilitates homeownership for borrowers unable to make substantial down payments. The 203(k) loans, as compared with conventional loans, offer greater underwriting flexibility than conventional loans, which makes the loans appealing to borrowers who may not otherwise qualify for mortgages. Borrowers obtaining 203(k) loans may establish additional banking relationships and accounts with lenders. In addition, banks making 203(k) loans may expand banking relationships with nonprofit housing developers.

### Profitability

The 203(k) program may help banks increase profitability in several ways. First, banks holding 203(k) loans in their portfolios earn interest they might not otherwise earn. Second, there is an active secondary market for FHA loans because the Government National Mortgage Association (Ginnie Mae) permits the placement, or “pooling,” of 203(k) loans in Ginnie Mae securities.<sup>12</sup> Finally, lenders say secondary-market transactions typically generate premiums of up to 3 percent of loan amounts, depending on rates, maturities, and market conditions. Table 1 shows that profitability in the secondary market for 203(k) loans varies based on the capacity of lenders to service and sell pools of the loans.

**Table 1: Estimated 203(k) Loan Fee Income for Lenders**

Lender capacity	Loan terms	Sales premium from investors	Servicing-fee income	First-year income
Without servicing and pooling capacity	\$250,000 at 4%, 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
With servicing and pooling capacity	\$250,000 at 4%, 30-year fixed rate	200 to 300 basis points \$5,000 to \$7,500	44 basis points <sup>a</sup> \$1,100	\$6,100 to \$8,600

Source: FHA

<sup>a</sup> The difference between the interest rate and the coupon rate of Ginnie Mae securities is 50 basis points. The servicing lender collects 44 basis points. Ginnie Mae collects 6 basis points as a guarantee fee.

<sup>10</sup> *There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values*, Dan Immergluck and Geoff Smith, the Woodstock Institute, Chicago, 2005. For a more recent study on the effect of foreclosures on nearby properties, see “Spillover Effects of Foreclosures on Neighborhood Property Values,” Zhenguang Lin, Eric Rosenblatt, and Vincent Yao, *The Journal of Real Estate Finance and Economics* 38, no. 4, 2009: 387-407. See [http://business.fullerton.edu/finance/zlin/forthcoming%20in%20JREFE%20-%20Spillover%20Effects%20of%20Foreclosure%20on%20Neighborhood%20Property%20Values\\_fullerton.pdf](http://business.fullerton.edu/finance/zlin/forthcoming%20in%20JREFE%20-%20Spillover%20Effects%20of%20Foreclosure%20on%20Neighborhood%20Property%20Values_fullerton.pdf).

<sup>11</sup> “Communities Become Home Buyers to Fight Decay,” Vikas Bajaj, *The New York Times*, August 26, 2008.

<sup>12</sup> Ginnie Mae permits 203(k) mortgages to be placed in GNMA I and II pools along with FHA 203(b) mortgages. Ginnie Mae guarantees the pass-through and timely payment of interest on the principal of the loan by the borrower to secondary-market investors. Once HUD endorses the 203(k) loan, the bank can immediately place it in a Ginnie Mae mortgage-backed security. For more information, visit [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/203k/203kmenu](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/203k/203kmenu).

The 203(k) loans generate more income for lenders than typical purchase mortgages because the rates on 203(k) loans are generally higher than market-based mortgage rates. Table 1 illustrates the typical profitability for lenders, based on whether they have the capacity to service 203(k) loans and pool them as Ginnie Mae securities.<sup>13</sup>

Lenders without servicing and pooling capacities typically sell to other lenders or loan aggregators. Through this process, 203(k) loan originators generate, depending on market conditions, an estimated \$1,875 to \$3,750 on a \$250,000 loan.<sup>14</sup> The potential profitability from secondary-market transactions is higher for lenders with the institutional capacity to service and sell 203(k) loans directly to investors. The potential first-year fee income, depending on market conditions, for originators with the capacity to originate, service, and sell pools of 203(k) loans ranges from an estimated \$6,100 to \$8,600 per loan.

### **Liquidity Management**

Liquidity management policies encourage banks to have sufficient assets on their books that can be, if needed, easily converted to cash. The 203(k) loans can easily be sold in the secondary mortgage market. Additionally, smaller banks without secondary-market experience can sell 203(k) loans to other lenders that have greater expertise with Ginnie Mae securities and institutional investors. By selling these loans or placing them in Ginnie Mae pools, banks may better manage their balance sheet liquidity.

### **Risk Mitigation and Regulatory Capital Requirements**

The 203(k) program provides 100 percent mortgage insurance against loan default, and that insurance is backed by the full faith and credit of the federal government. When a loan defaults, the FHA pays the lender the remaining unpaid principal balance of the loan.<sup>15</sup> This greatly reduces the risk banks face in originating and holding 203(k) loans. Under the regulatory agencies' current risk-based capital requirements, loans guaranteed by the federal government through the FHA are risk-weighted at 20 percent.

### **Community Reinvestment Act**

Originated and purchased FHA 203(k) loans are considered to be home mortgage loans under the Community Reinvestment Act (CRA) lending test applicable to banks. The FHA 203(k) loans that banks make to low- or moderate-income individuals or that benefit low- or moderate-income areas may positively affect the Office of the Comptroller of the Currency's (OCC) evaluation of the banks' mortgage portfolios, geographic distributions, and borrower characteristics.

In addition, banks may receive favorable consideration under CRA for providing technical assistance on financial matters to nonprofits whose primary purpose meets the CRA definition of community development.<sup>16</sup> For example, under the 203(k) program, banks may provide technical assistance to nonprofits providing affordable housing for low- or moderate-income individuals through the purchase and rehabilitation of

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<sup>13</sup> Smaller lenders typically do not have the capacity to service 203(k) loans or sell these assets in pools to investors. As a result, smaller lenders may sell their 203(k) loans to larger lenders that do this.

<sup>14</sup> 203(k) loans are typically priced at the standard 203(b) rate plus a premium of half a percentage point.

<sup>15</sup> For more information, see "Allowable Attorney Fees and Foreclosure and Acquisition Costs on FHA Single Family Claims" at [www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/91-14ml.txt](http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/91-14ml.txt).

<sup>16</sup> See "Interagency Questions and Answers Regarding Community Reinvestment," 75 *Federal Register* (FR) 47 (March 11, 2010), p. 11642 12(i)-3 at [www.gpo.gov/fdsys/pkg/FR-2010-03-11/html/2010-4903.htm](http://www.gpo.gov/fdsys/pkg/FR-2010-03-11/html/2010-4903.htm).

foreclosed properties in the banks' assessment areas. Banks also may receive favorable CRA consideration for purchasing mortgage-backed securities 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).<sup>17</sup> Banks, however, may not receive CRA consideration if they buy mortgage-backed securities that are primarily or exclusively backed by residential mortgage loans that have been considered under the bank's lending test.<sup>18</sup>

Also, banks may receive positive CRA consideration for certain activities supporting neighborhood stabilization.<sup>19</sup> For example, banks participating in partnerships and making in-kind donations of other real estate owned (OREO) properties to nonprofits whose primary purpose is consistent with the CRA definition of community development may receive favorable CRA consideration.<sup>20</sup> 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. As a result, the bank could provide a 203(k) loan to a nonprofit to facilitate a property's rehabilitation. Under this scenario, the bank may receive CRA consideration for both its investment and the 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 FHA 203(k) Loan Program Work?**

The 203(k) program offers two types of loans: Standard(k) and Streamlined(k). Both allow borrowers to finance the purchase price of properties, closing costs, and repair costs. Both require relatively low down payments of only 3.5 percent of gross loan amounts. In the private market, conventional rehabilitation mortgages typically require a down payment of 10 to 20 percent. In other ways, the terms of the Standard(k) and Streamlined(k) loans differ. The following paragraphs explain how the programs differ.

#### **Standard(k)**

The Standard(k) loan helps borrowers who need to do extensive structural work and repairs on properties at costs exceeding \$35,000. For example, a borrower may add a room, remove interior or external walls, or make other significant repairs. At least \$5,000 of a Standard(k) loan must be used toward repairs; however, there is no maximum repair amount, as long as the total acquisition and rehabilitation costs do not exceed the maximum loan amount. A Standard(k) mortgage, depending on location, can range from \$271,050 to \$729,750. See appendix C for more information on the mortgage limits.

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<sup>17</sup> *Ibid.*, \_\_.12(t)-2.

<sup>18</sup> *Ibid.*, .23(b)-2.

<sup>19</sup> In 2010, the CRA definition of community development was amended to broaden eligibility for consideration of NSP-related activities. The amendment extended CRA consideration to community development activities that benefit middle-income individuals and areas and allowed consideration of activities in the bank's assessment area(s) or outside the bank's assessment area(s), provided the bank adequately addressed the community development needs of its assessment area(s). For more information, see 75 FR 243 (December 20, 2010), p. 79278 and [www.gpo.gov/fdsys/pkg/FR-2010-12-20/html/2010-30473.htm](http://www.gpo.gov/fdsys/pkg/FR-2010-12-20/html/2010-30473.htm).

<sup>20</sup> See "Interagency Questions and Answers Regarding Community Reinvestment," 75 FR 47 (March 11, 2010), p. 11642, 12(t)-4 and 12(t)-5 at [www.gpo.gov/fdsys/pkg/FR-2010-03-11/html/2010-4903.htm](http://www.gpo.gov/fdsys/pkg/FR-2010-03-11/html/2010-4903.htm).

The Standard(k) loan cannot exceed 110 percent of the “as-improved” value.<sup>21</sup> Additionally, if the property cannot be occupied during the rehabilitation phase, the borrower may include six months of mortgage payments in the loan amount to pay the loan while living elsewhere. 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.

### Streamlined(k)

The Streamlined(k) loan places fewer demands on borrowers. The goal is to assist potential homeowners with financing less complicated and lower-cost rehabilitation projects. Streamlined(k) loans are recommended for small projects that are largely cosmetic and do not require structural changes to houses.<sup>22</sup> The maximum repair portion of these loans is \$35,000; however, there is no minimum.<sup>23</sup> Cosmetic improvements include replacing appliances, flooring, windows, and doors. Borrowers can use this loan to replace heating, ventilation, or air conditioning systems, as well as for painting and minor roof repairs. Borrowers who use Streamlined(k) loans are not required to use an FHA-designated consultant.<sup>24</sup> Table 2 compares the terms of the Standard(k) and Streamlined(k) loans.

**Table 2: Comparison of Standard(k) and Streamlined(k) Loans**

Loan option	Maximum loan amount	Percent insured	Use of proceeds	Down payment	Maturity	Interest rates	Eligible property
<b>Standard(k)</b>	FHA sets limits by geographic area; loans cannot exceed \$729,750 with purchase, rehabilitation costs (repair minimum of \$5,000) plus related financing fees	100% of outstanding loan balance	Acquire property and substantially expand or renovate it	3.5%	15 or 30 years at fixed or adjustable rates	Typically 0.5% higher than market rates	1-to 4-unit family properties only, and properties must be owner-occupied
<b>Streamlined(k)</b>	FHA sets limits by geographic area; loans cannot exceed \$729,750 with purchase, refinancing, and rehabilitation costs (repair maximum of \$35,000)	100% of outstanding loan balance	Acquire property and make minor or cosmetic improvements	3.5%	15 or 30 years at fixed or adjustable rates	Typically 0.5% higher than market rates	1-to 4-unit family properties only, and properties must be owner-occupied

<sup>21</sup> The “as-improved” value of the home refers to the estimated market value of the home after the rehabilitation work is finished.

<sup>22</sup> Structural change refers to the removal of walls or supports, which can compromise a building’s structural soundness.

<sup>23</sup> The Streamlined(k)’s \$5,000 minimum loan requirement was removed in 2005. See FHA Mortgagee Letter 05-50, December 29, 2005. For more information, see [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/letters/mortgagee/2005ml](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee/2005ml).

<sup>24</sup> Some lenders require borrowers to meet with a professional consultant to review their repair plans. The lenders require this as a safety and soundness measure; however, the FHA does not require this for Streamlined (k) loans.

## Eligible Borrowers

Borrowers who meet the underwriting qualifications for the more traditional 203(b) FHA mortgage insurance program also are eligible to receive 203(k) loans.<sup>25</sup> The 203(k) borrowers, however, must occupy FHA-financed homes.<sup>26</sup> Profit-motivated investors are not eligible for 203(k) loans.

Nonprofit organizations approved by FHA, and certain government agencies, are eligible borrowers, although certain restrictions apply.<sup>27</sup> Before loans are made, the FHA must approve, through HUD's Homeownership Centers, nonprofits and government agencies as borrowers.<sup>28</sup> This approval gives nonprofits the opportunity to obtain financing to restore foreclosed properties. Nonprofits can use the program to rehabilitate foreclosed FHA-owned, city-owned, and OREO properties. Nonprofit developers and government agencies, however, may not finance more than 10 incomplete 203(k) properties at any one time.<sup>29</sup>

Also, the down payments required of these borrowers are higher. Individual borrowers are required to make down payments of 3.5 percent; nonprofits and public agencies must put down 5 percent.<sup>30</sup>

## Eligible Properties

To qualify for the program, properties must be one- to four-family dwellings that, if newly constructed, have been completed for at least one year. The 203(k) loan can be used to convert a single-family unit into a two-, three-, or four-family dwelling or to convert a multifamily dwelling 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 their existing foundations remain intact. The number of units must comply with local zoning. Mixed-use properties qualify when space designated for commercial is 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.

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<sup>25</sup> The 203(b) FHA mortgage is the standard FHA mortgage; however, the 203(b) mortgage cannot be used for rehabilitation costs. For more information on 203(b) mortgage insurance, visit [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/ins/203b--df](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/ins/203b--df).

<sup>26</sup> Individual borrowers may own additional properties, but they must live in FHA-financed homes.

<sup>27</sup> See FHA Mortgagee Letter 00-8, "Nonprofit Agency Participation in Single Family FHA Activities," March 3, 2000, at [www.fha-lending.com/CD/Mortgagee%20Letters/2000%20Mortgagee%20Letters/ml00-08.pdf](http://www.fha-lending.com/CD/Mortgagee%20Letters/2000%20Mortgagee%20Letters/ml00-08.pdf). The letter restricts 203(k) lending by nonprofit agencies so they will not overextend their financial and management capabilities. A nonprofit agency is prohibited from borrowing under the 203(k) program if the agency has 10 or more incomplete 203(k) developments at one time. Also, a borrower cannot have more than seven units within a two-block radius of the property it wants to purchase. The seven-unit limitation does not apply, however, if 1) the neighborhood has been targeted by a state or local government for redevelopment or revitalization; and 2) 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 by HUD within a redevelopment area or sub-area to prevent undesirable concentrations of units under single or group ownership. HUD will determine that the seven-unit limit is inapplicable only if: 1) the real estate owner/entity will own no more than 10 percent of the housing units (regardless of financing type) in the designated redevelopment area or sub-area; and 2) the real estate owner/entity has no more than eight units on adjacent lots.

<sup>28</sup> The location of FHA Homeownership Centers can be found at [www.hud.gov/offices/hsg/sfh/hoc/hsgdocs.cfm](http://www.hud.gov/offices/hsg/sfh/hoc/hsgdocs.cfm).

<sup>29</sup> The FHA defines 203(k) properties as being completed if all rehabilitation and construction work is finished, properties sold, and loans paid off, or alternatively, if the properties are tenant-occupied and the rent revenue exceeds all property expenses. For more information, see FHA Mortgagee Letter 00-8, March 3, 2000, at [www.fha-lending.com/CD/Mortgagee%20Letters/2000%20Mortgagee%20Letters/ml00-08.pdf](http://www.fha-lending.com/CD/Mortgagee%20Letters/2000%20Mortgagee%20Letters/ml00-08.pdf).

<sup>30</sup> Some lenders reported having reservations about extending 203(k) loans to nonprofits. They preferred to consider lending only to nonprofits with sufficient real estate construction and housing sales experience, as well as strong connections to local government agencies. See [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/203k/203kabou](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/203k/203kabou).

For these properties, rehabilitation funds must be used exclusively for areas designated for residential use. Residential units designated as “cooperatives” are not eligible, but condominium units may qualify with some restrictions.<sup>31</sup>

### Eligible Uses

Eligible uses for 203(k) loans<sup>32</sup> include room additions, deck installations, and replacement of heating and air conditioning systems. The program promotes cost-effective energy conservation and renewable-energy upgrades, requiring weather-stripping steps that help ensure the integrity of the building’s envelope. Table 3 lists some examples of eligible improvements under the Standard(k) and Streamlined(k) guidelines.

**Table 3: Examples of Eligible Improvements With Standard(k) and Streamlined(k) Loans**

Standard(k)	Streamlined(k)
Additional rooms	Minor repairs to roofs, gutters, and downspouts
Septic and well systems	Interior or external painting
Total plumbing replacements	Minor plumbing and electrical repairs
Major chimney repairs	New flooring, including carpet, wood, and tile
Major repairs to roofs, kitchens, and baths	Minor kitchen and bath remodeling

Source: FHA

### Preliminary Steps for Borrowers

Several steps and procedures need to be followed to complete successful 203(k)-financed home rehabilitation projects. Borrowers, most likely working with real estate agents, first locate suitable properties to purchase and identify FHA-approved lenders. The FHA offers a Web-based search tool to help borrowers find FHA-approved lenders.<sup>33</sup>

### FHA Designation for Lenders

Lenders must be FHA-approved to offer any FHA products, including 203(k) loans. Once banks file online applications to be approved as FHA lenders, the FHA’s approval process typically takes 30 to 45 days to process applications and make final decisions.<sup>34</sup> Lenders pay a \$1,000 FHA-designation application fee.<sup>35</sup>

### Consultants and Appraisers

Under the Streamlined(k) program, a borrower may develop the work write-up and cost estimate or use an independent consultant or a contractor to prepare these items.

<sup>31</sup> 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 condominiums should refer to [www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm](http://www.hud.gov/offices/hsg/sfh/203k/203kabou.cfm).

<sup>32</sup> Improvements not eligible for 203(k) financing 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 [www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm](http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm).

<sup>33</sup> See HUD’s lender list at [www.hud.gov/ll/code/lslcrit.cfm](http://www.hud.gov/ll/code/lslcrit.cfm).

<sup>34</sup> See the online application portal at [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/lender/lendappr](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/lender/lendappr).

<sup>35</sup> 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.

Under the Standard(k) program, a HUD-approved 203(k) fee consultant must develop an in-depth construction plan, with architectural exhibits, along with an accurate cost assessment.<sup>36</sup> Once the write-up is complete, an FHA-approved appraiser must estimate the future value of the property after work is completed.<sup>37</sup> 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.

### **Underwriting**

The FHA has developed underwriting guidelines that are embedded in the TOTAL Mortgage Scorecard and incorporated in automated underwriting systems to evaluate the creditworthiness of borrowers.<sup>38</sup> Lenders must submit information about the borrowers, loans, and financed properties using an automated online underwriting system. The automated system evaluates whether the borrower has the ability to repay the loan. Applications not initially qualified through the automated system can be manually underwritten by an originating lender's FHA-approved direct endorsement underwriters, who are unconditionally approved to make credit decisions concerning 203(k) loans. 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**

The closing process for the FHA 203(k) loan is similar to that of a typical FHA 203(b) loan; however, the 203(k) loan requires the completion of a Rehabilitation Loan Agreement and the creation of a Rehabilitation Escrow Account. The Rehabilitation Loan Agreement between a borrower and lender establishes the conditions under which the lender releases rehabilitation funds. The borrower is required to make mortgage payments to the lender based on the outstanding principal amount, including any escrow account balance that has not yet been disbursed. Under the Standard(k) program, however, the borrower may include the cost of up to six months of mortgage payments in the rehabilitation budget to cover these payments while the property is not habitable. After closing, the bank must submit a copy of the mortgage documents to the FHA, and the FHA mortgage insurance becomes effective upon endorsement of the documents. Lenders submit documentation materials through the FHA's online system, called the FHA Connection.

### **Construction Phase**

The FHA requires borrowers to complete rehabilitation within six months. Some lenders may establish shorter construction periods, depending on the amount of work needed. As construction progresses, banks disburse funds from Rehabilitation Escrow

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<sup>36</sup> A list of HUD-approved 203(k) fee consultants can be found at <https://entp.hud.gov/idapp/html/fl7cnsldata.cfm>. HUD-approved consultants conduct cost estimations validated by industry-published tables from RS Means, Marshall & Swift, and Homotech to ensure pricing accuracy in the markets where properties are located.

<sup>37</sup> Find FHA-approved appraisers at <https://entp.hud.gov/idapp/html/apprlook.cfm>.

<sup>38</sup> See the "FHA TOTAL Mortgage Scorecard User Guide," July 18, 2012, at [http://portal.hud.gov/hudportal/documents/huddoc?id=total\\_userguide.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=total_userguide.pdf).

Accounts after completed work is reviewed by FHA-approved inspectors.<sup>39</sup> A 10 percent holdback is placed on construction phases until all outstanding contracts are complete.<sup>40</sup> The FHA allows for four draws from the Rehabilitation Escrow Account during the construction phase. The 10 percent holdback is required every time draws are made from Rehabilitation Escrow Accounts. The 10 percent holdback can only be released after final inspection of the rehabilitation and issuance of the Final Release Notice.

### **Final Inspection**

When repairs are completed, borrowers request final inspections. After final inspections are done, all funds from Rehabilitation Escrow Accounts, including the required 10 percent holdbacks, may be released. If there is money left in escrow accounts, borrowers may use the funds to pay down mortgages or to make additional improvements not included in initial plans.

### **Marketing**

Lenders indicated that 203(k) customers are found in two ways: by marketing to real estate agents and by marketing directly to customers. Many 203(k) lenders establish relationships with local real estate agents who specialize in locating properties in need of repair. Some lenders also attend professional association meetings of real estate agents to market 203(k) products. In addition, because many borrowers are unaware of the 203(k) program, banks often market 203(k) loans to customers initially seeking conventional financing on properties requiring improvements.

### **Bank Administration of the Program**

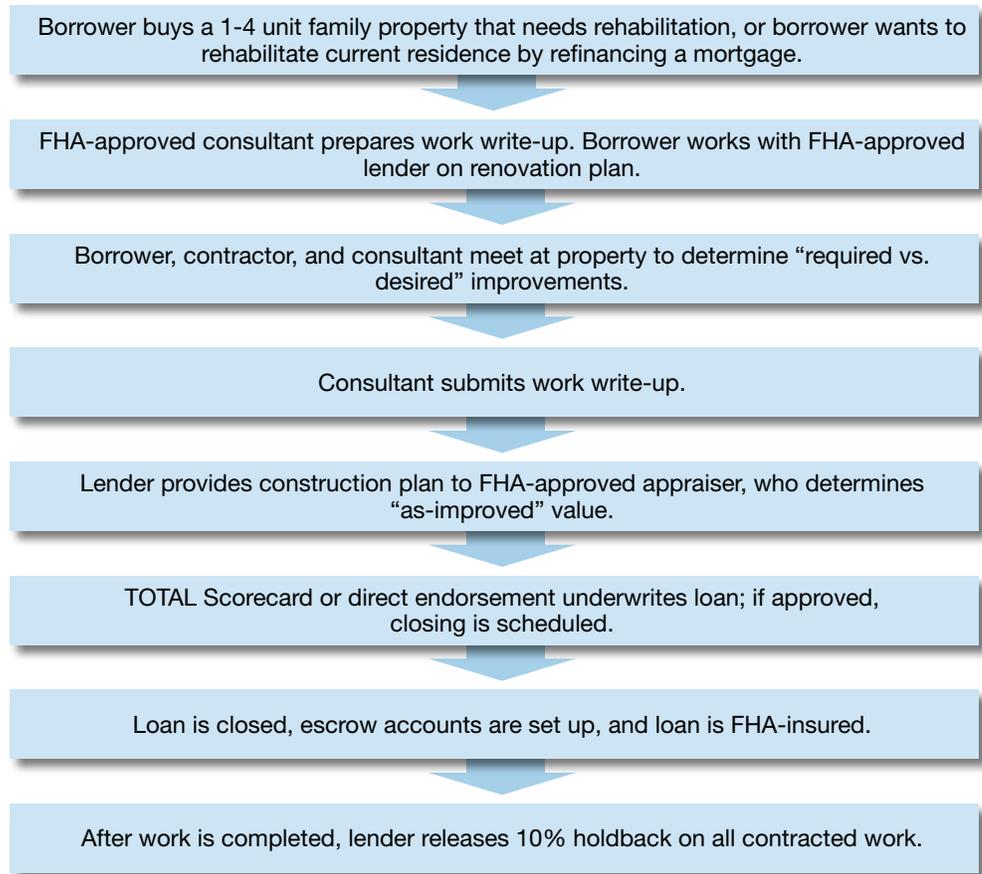
The number of people on a bank's lending staff who are dedicated to 203(k) products depends on the bank's business model and whether government lending is central to its overall strategy. One key to offering 203(k) loans successfully is to have the capacity to approve and monitor construction draws. Some banks do this internally through 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 or two staff members who specialize in originating, underwriting, and administering these loans. Figure 2 shows a financing flow chart for a Standard(k) loan.

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<sup>39</sup> Find FHA-approved inspectors at [https://entp.hud.gov/idapp/html/insplook.cfm?in\\_fha=No](https://entp.hud.gov/idapp/html/insplook.cfm?in_fha=No).

<sup>40</sup> For properties older than 30 years and requiring repairs of more than \$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 applies only to Standard(k) loans, not Streamlined(k) loans. For more information, see [www.fha.com](http://www.fha.com).

**Figure 2: Flow Chart Showing How a Standard(k) Loan Works**



Source: OCC

## **IV. What Are the Key Risks and Regulatory Considerations?**

### **Underwriting**

The TOTAL Mortgage Scorecard, the FHA's automated underwriting system, and the approval process for direct endorsement underwriters, help ensure that 203(k) loans are originated in a safe and sound manner. Lenders said their 203(k) loans 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 they are funded.

### **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 initial funding, 203(k) loans are 100 percent FHA-insured. However, the risk of default rises because of construction cost overruns, which might prematurely deplete the escrow account and leave borrowers at risk of being unable to pay. It should be noted, however, that 203(k) loans permit the establishment of a construction contingency reserve to mitigate the risk of cost overruns. Lenders said a thorough review of the selected contractors is critical to increasing the probability that projects will be completed on

time and on budget. This includes reviewing contractor references and disclosures and ensuring contractors have all required work permits before loans are closed. Lenders also recommended that proposed changes to the cost of rehabilitation work be carefully examined.

### **Operational and Reputation Risk**

More than a decade ago, fraud by certain lenders and nonprofits stigmatized the 203(k) program.<sup>41</sup> While the 203(k) program has operated more effectively over the past decade, lenders said due diligence is required to ensure the eligibility of borrowers. Some say that investors, who are not eligible, occasionally try to obtain 203(k) loans, so banks must conduct proper checks to verify that borrowers will occupy financed homes. In addition, banks offering the 203(k) loans through third parties must conduct due diligence to ensure selection of reliable partners that have the capacity to originate and manage 203(k) loans effectively.

Some lenders suggest that careful oversight of consultants and appraisers also is necessary to decrease the risk of fraud. Lenders suggest that in the past, the FHA randomly checked project sites to ensure that repairs were properly completed. More recently, FHA oversight has decreased. Some interviewees stress that increased FHA oversight of consultants might reduce risk associated with the program. The FHA will deny mortgage insurance claims on defaulted loans where fraud is identified.

### **Default Management Risk**

Lenders must carefully follow FHA loan servicing guidelines to obtain 100 percent reimbursement of the 203(k) loan value if borrowers default.<sup>42</sup> Lenders must have effective quality-control procedures to ensure that FHA guidelines are followed throughout loan origination, rehabilitation, and foreclosure processes. Lenders who do not fully comply with FHA guidelines may impair their mortgage insurance claims and possibly incur HUD financial penalties.<sup>43</sup>

### **Compliance and Fair Lending Risk**

Lenders offering 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).

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<sup>41</sup> See “The Harlem Shuffle,” Kemba Johnson, *City Limits*, November 1999, at [www.citylimits.org/news/articles/2420/the-harlem-shuffle](http://www.citylimits.org/news/articles/2420/the-harlem-shuffle).

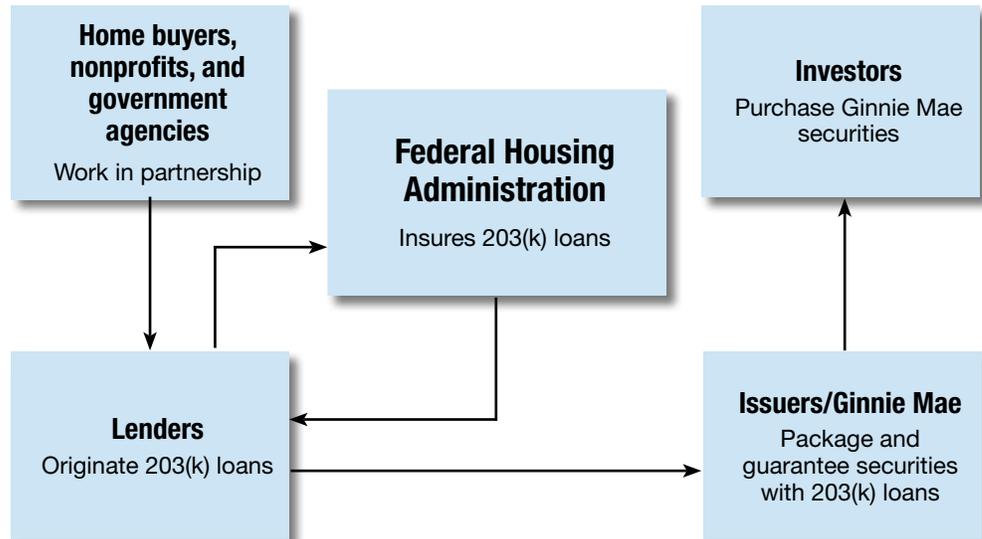
<sup>42</sup> For 203(k) loan origination and servicing rules, see the FHA’s 203(k) handbook at [www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm](http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm).

<sup>43</sup> Rebecca Walzak, “Pitfalls of FHA,” *Mortgage Banking*, March 2009, at [www.financemetric.shopperspick.com/index.php/store/productinfo/ASIN/B001WO29BG](http://www.financemetric.shopperspick.com/index.php/store/productinfo/ASIN/B001WO29BG).

## 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). Although 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 shows how the key players in the 203(k) loan process interact.

**Figure 3: Key Players in the 203(k) Loan Program**



Source: FHA

### Home Buyers, Nonprofits, and Government Agencies

Individual home buyers, 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 a sufficient down payment (i.e., less than 20 percent) and are purchasing foreclosed properties.<sup>44</sup>

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 section 602 Nonprofit Disposition Program.<sup>45</sup> Local governments can combine 203(k) financing with other federal funds, such as financing through the HOME, CDBG, and NSP programs, to

<sup>44</sup> Lenders indicated that those who want to upgrade but are unable to sell opt to take out 203(k) loans to renovate or expand their homes.

<sup>45</sup> See 12 USC 1710(h), also known as section 602 of the Department of Veterans Affairs and Housing and Urban Development and Independent Agencies Appropriations Act, 1999 (Public Law 105-276, approved October 21, 1998), which amended section 204 of the National Housing Act (12 USC 1710) (NHA or the statute) by adding a new subsection (h), which provides the statutory framework for a new program for the disposition of HUD-owned single-family assets in revitalization areas (see 12 USC 1710(h)). In 2004, section 204(h) was further amended by the Consolidated Appropriations Act, 2005 (Public Law 108-447, approved December 8, 2004). Under section 204(h) of the NHA, HUD makes HUD-held single-family homes and formerly insured mortgages on single-family properties, referred to as "eligible assets," "available for sale in a manner that promotes the revitalization, through expanded homeownership opportunities, of revitalization areas" (12 USC 1710(h)(1)). All properties involved are HUD-held properties; that is, they are properties that were subject to a mortgage insured by HUD and are now owned by HUD pursuant to the payment of insurance benefits under the NHA and the implementing regulations for the NHA programs that are codified in Chapter II of Title 24 of the Code of Federal Regulations (CFR).

purchase and rehabilitate bank-owned or HUD-owned properties.<sup>46</sup> A few state housing finance agencies have initiatives to help new homeowners purchase vacant properties. Greater use of the 203(k) program might help strengthen local rehabilitation efforts emerging nationwide.<sup>47</sup>

### **Lenders and the FHA**

The 203(k) loan market has more than 275 participating lenders, including large and small national banks and independent mortgage companies. The FHA works only with approved 203(k) lenders.

### **Issuers, Ginnie Mae, and Investors**

Issuers, including such conduits as loan aggregators and investment banks, Ginnie Mae, and investors are important secondary-market participants, which, 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 loan aggregators or investment banks, which bundle these loans and issue Ginnie Mae securities, backed in part by pools of 203(k) loans. The FHA insures the underlying loans against borrower default, and 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 Do the 203(k) Cost Structure and 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 one-half percentage point higher than regular FHA 203(b) loans. Lenders can offer 15-year 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

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<sup>46</sup> See “Communities Become Home Buyers to Fight Decay,” Vikas Bajaj, *The New York Times*, August 26, 2008.

<sup>47</sup> State and local efforts to revitalize vacant and foreclosed homes are occurring nationwide. For more information, see the following articles: “Living Cities, Mitigating the Impact of Concentrated Foreclosures on Neighborhoods,” Washington, D.C., 2008, and “WHEDA Pairs First-time Buyers, Foreclosed Houses,” by Joanne Cleaver, *Milwaukee Journal Sentinel*, May 18, 2008, at [www.jsonline.com/news/wisconsin/29579954.html](http://www.jsonline.com/news/wisconsin/29579954.html); and Sharon Canavan, “Property Disposition: Exploring Different Approaches to Preserving Affordable Housing Opportunities,” OCC, March 2009, at [www.occ.gov/topics/community-affairs/publications/insights/insights-property-disposition.pdf](http://www.occ.gov/topics/community-affairs/publications/insights/insights-property-disposition.pdf).

single-family properties.<sup>48</sup> For Standard(k) loans, the improvement portion of the loan has no limit, 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. Recently, the FHA removed the 1 percent origination fee cap from the 203(k) program and clarified that the *supplemental* origination fee permitted under this program is not affected.<sup>49</sup> 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. The annual FHA mortgage insurance premium, charged to the borrower on the outstanding loan balance, depends on the loan term, loan-to-value ratio, and loan size.<sup>50</sup> The mortgage insurance premium is necessary to ensure that the FHA has adequate reserves to cover loan defaults.

Certain fees accompany the construction and repair process. For Standard(k) loans, a consultant approved by the FHA is needed to draft the construction plans. The fee for this service is capped at \$500 and 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 inspector 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 an example of the primary and customary 203(k) loan fees.

## **VII. What Factors Have Constrained 203(k) Loan Growth?**

### **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

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<sup>48</sup> These mortgage limits are effective through December 31, 2013. For more information, see appendix C and FHA Mortgagee Letter 2012-26 at <http://portal.hud.gov/hudportal/documents/huddoc?id=11-39ml.pdf>.

<sup>49</sup> See FHA Mortgagee Letter 2011-18, “Elimination of FHA’s origination fee cap for the 203(k) Rehabilitation Mortgage Insurance Program,” April 26, 2011, at <http://portal.hud.gov/hudportal/documents/huddoc?id=11-18ml.pdf>.

<sup>50</sup> See FHA Mortgagee Letter 2012-4, “Single Family Mortgage Insurance: Annual and Up-Front Mortgage Insurance Premium—Changes,” March 6, 2012, at <http://portal.hud.gov/hudportal/documents/huddoc?id=12-04ml.pdf>.

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 estimated 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 the lending institution. Because loan officers and real estate agents want to close loans efficiently and rapidly, they often overlook the 203(k) program. In today's market, however, the 203(k) product might be the only loan product that fits the needs of a particular borrower set. With the large inventory of foreclosed properties that need repairs, 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 said the FHA should require inspections for each draw made under a Streamlined(k) loan. Lenders said the Streamlined(k) product is easier for borrowers but 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. This risk is often mitigated, however, by lender-driven checks on contracted work. Some lenders we spoke to establish their own required inspections for Streamlined(k) draws.

### **Investor Participation**

Investors and non-owner occupants (except for nonprofits and government agencies) are prohibited from participating in the 203(k) program. Several lenders, however, 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 some lenders said investors have a greater capacity and more experience to efficiently repair and manage these properties.

## **VIII. Conclusion**

When used effectively and properly, FHA 203(k) loans allow individual borrowers, nonprofits, and communities to improve residential properties, preserve homeownership, and revitalize neighborhoods. By simplifying the loan approval process and providing 100 percent insurance, the program reduces lender risk and improves lender liquidity while enhancing loan profitability and regulatory compliance. Moreover, in today's market, 203(k) loans help banks reduce the inventory of foreclosed and deteriorating homes across the nation.

Banks can use 203(k) loans to develop new businesses and expand their customer base, especially in high-cost markets where borrowers are unable to make large down payments. In addition, federal funds allocated for neighborhood stabilization provide banks opportunities to expand relationships with state and local governments and nonprofit organizations. Banks also may receive positive CRA consideration for making and buying 203(k) loans. Very few conventional mortgage and rehabilitation loans offer equivalent flexibility, guarantees, and return.

## Appendix A

This table illustrates the basic costs associated with a Standard(k) loan that totals \$250,000, including a \$200,000 purchase price and \$50,000 rehabilitation budget.

### Typical Costs and Fees Associated With Standard(k) Loans

Basic costs and fees	
Purchase price	\$200,000
Rehabilitation costs	\$50,000
Total purchase plus rehabilitation costs	\$250,000
Total 30-year fixed-rate mortgage after 3.5% or \$8,750 down payment	\$241,250
Mortgage rate (based on HUD estimate that rates average half a percentage point higher than standard FHA rates, currently 3.5%)	4%
Closing costs, upfront insurance premium, etc. (see secondary fees)	\$7,221
FHA annual insurance fee (Rate of 1.25%, with loan term more than 15 years, base loan amount \$625,500 or less, and loan-to-value ratio 95.01% or more)	\$3,018.39 (\$251.53 in monthly installments)
Monthly payment including principal, interest, and mortgage insurance premium	\$1,403.29
Additional costs and 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 also can use the loan to cover monthly mortgage payments for up to six months or until the property is liveable.	
Up-front FHA mortgage insurance premium	1.75% \$4,221
Consultant fee for architectural plan	\$500
Inspection fees at \$50 a visit (up to five inspections)	\$250
Lender fee of a maximum 1.5% of rehabilitation costs	\$750
Closing cost (estimate)	\$1,500
Total fees	\$7,221
Loan-to-value calculation	
Total 30-year loan amount plus mortgage insurance premium and excluding down payment of \$8,750	\$245,471
Fees and closing costs	\$3,000
As-improved value	\$250,000
Loan-to-value	99.4%

Source: FHA and OCC

## **Appendix B**

### **Resource Directory**

#### **203(k) Program Overview**

[www.hud.gov/offices/hsg/sfh/203k/203kmenu.cfm](http://www.hud.gov/offices/hsg/sfh/203k/203kmenu.cfm)

#### **203(k) Program Questions and Answers**

[www.hud.gov/offices/hsg/sfh/203k/faqs203k.cfm](http://www.hud.gov/offices/hsg/sfh/203k/faqs203k.cfm)

#### **203(k) Handbook**

[www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm](http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4240.4/index.cfm)

#### **HUD Lookup Tool for Mortgage Limits in High-Cost Areas (County by County)**

<https://entp.hud.gov/idapp/html/hicostlook.cfm>

## Appendix C

### FHA 203(k) Loan Limits

The maximum mortgage insurance limits are the same for FHA 203(k) and 203(b) loans. These limits apply nationwide, without regard to variances in median home prices (referred to as the “floor” by the FHA and lenders). The floor is set at 65 percent of the national conforming loan limit, which in 2012 was \$417,000 for a one-unit single-family property. The FHA adjusts the floor annually to reflect changing home prices.

The FHA sets higher mortgage insurance limits for properties in higher-cost geographic areas the FHA calls “high-cost areas.” High-cost area limits are set at 115 percent of the median area home price, with a cap of 175 percent of the national conforming loan limit of \$417,000.

### FHA 203(k) Loan Limits

For 2012, the floor limits in most areas of the nation for one- to four-family units are:	
One-family unit	\$271,050
Two-family unit	\$347,000
Three-family unit	\$419,425
Four-family unit	\$521,250
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
Note: These limits were valid through December 31, 2012. <sup>a</sup>	

Source: FHA

<sup>a</sup> See FHA Mortgagee Letter 2011-39 and HUD’s lookup tool to find high-cost area loan limits by county at <http://entp.hud.gov/idapp/html/hicostlook.cfm>.

William Reeves was the primary author of this *Community Developments Insights* report, which updates a 2009 *Insights* report authored by Derek Hyra. Sharon Canavan, Hershel Lipow, and Barry Wides contributed to this update. *Community Developments 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 report was obtained from individuals and publicly available sources that are considered reliable. The use of this information, however, does not constitute an endorsement of its accuracy by the Office of the Comptroller of the Currency.