

## Q&A: FHA Rehabilitation 203(k) Mortgage

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**1. 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.

**2. 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).

**3. Can Section 203(k) be used to improve a condominium unit?** Yes, however, condominium rehabilitation is subject to the following conditions:

- A. Owner/occupant and qualified non-profit borrowers only;
- B. Rehabilitation is limited only to the interior of the unit. Mortgage proceeds are not to be used for the rehabilitation of exteriors or other areas which are the responsibility of the condominium association, except for the installation of firewalls in the attic for the unit;
- C. Only the lesser of five units per condominium association, or 25 percent of the total number of units, can be undergoing rehabilitation at any one time;
- D. The maximum mortgage amount cannot exceed 100 percent of after-improved value. After rehabilitation is complete, the individual buildings within the condominium must not contain more than four units. By law, Section 203(k) can only be used to rehabilitate units in one-to-four unit structures. However, this does not mean that the condominium project, as a whole, can only have four units or that all individual structures must be detached. Example: A project might consist of six buildings each containing four units, for a total of 24 units in the project and, thus, be eligible for Section 203(k). Likewise, a project could contain a row of more than four attached townhouses and be eligible for Section 203(k) because HUD considers each townhouse as one structure, provided each unit is separated by a 1 1/2 hour firewall (from foundation up to the roof). Similar to a project with a condominium unit with a mortgage insured under Section 234(c) of the National Housing Act, the condominium project must be approved by HUD prior to the closing of any individual mortgages on the condominium units.

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

**5. 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.

**6. 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.

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

- A. 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.).
- B. 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).
- C. Elimination of health and safety hazards (including the resolution of defective paint surfaces or lead-based paint problems on homes built prior to 1978).
- D. Changes for aesthetic appeal and elimination of obsolescence (e.g., new exterior siding, adding a second story to the home, covered porch, stair railings, and attached carport).
- E. 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.
- F. 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.
- G. Roofing, gutters and downspouts.
- H. Flooring, tiling and carpeting.

I. Energy conservation improvements (e.g., new double pane windows, steel insulated exterior doors, insulation, solar domestic hot water systems, caulking and weather stripping, etc.).

J. Major landscape work and site improvement (e.g., 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.)

K. Improvements for accessibility to a disabled person (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.

**8. 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.

**9. 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 six months); the lender should not allow a time period longer than that required to complete the work.

**10. 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.

**11. 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.

**12. 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.

**13. 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.

**14. 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.

**15. 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.

**16. 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.

**17. 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.

**18. Can a Section 203(k) mortgage be an Adjustable Rate Mortgage?** Yes. An Adjustable Rate Mortgage is available to an owner-occupant only. Investors and non-profits are not eligible for an ARM.

**19. 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. A preclosing review in the new HUD office will not be necessary.

**20. 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.

**21. Can an investor use the 203(k) program?** No. In October, 1996, the Department placed a moratorium on investor participation in the 203(k) Rehabilitation Mortgage Program.

**22. 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.

**23. Can mortgage payments (PITI) be included in the mortgage?** Yes. Up to six months of payments may be included in the mortgage if the property is not occupied during the rehabilitation period.

24. **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.
25. **Can a dwelling be converted to provide access for a disabled person?** 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.
26. **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.
27. **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.
28. **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.
29. **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.
30. **Is there anyone available who can prepare the Work Write-up 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.
31. **Can the borrower do their own work write up 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 Write-up.
32. **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.
33. **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 this seven unit limitation does not apply.
34. **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.

**35. 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.

**36. 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

**37. 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

**38. Can an Energy Efficient Mortgage (EEM) be allowed using the 203(k) program?** Yes. A borrower can finance into the mortgage 100 percent of the cost of eligible energy efficient improvements, subject to certain dollar limitations, without an appraisal of the energy improvements and without further credit qualification of the borrower.

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