U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

April 26, 1996

MORTGAGEE LETTER 96-21

TO: ALL APPROVED MORTGAGEES
ALL STATE AND LOCAL HOUSING AGENCIES
ALL NON-PROFIT ORGANIZATIONS

SUBJECT: Single Family Loan Production - Using 203(k) Rehabilitation Mortgage Insurance with Participation by State and Local Housing Agencies and Non-Profit Organizations

This Mortgagee Letter contains information to help lenders, State and local officials and nonprofit organizations use the FHA 203(k) Rehabilitation Mortgage Insurance Program in conjunction with housing grant programs, such as HOME, HOPE 3 and Community Development Block Grants (CDBG).

The 203(k) program is one of the most flexible and affordable housing programs in the country today. It is the Department's primary insurance program for the rehabilitation and repair of single family properties for either homeownership or rental purposes. It can help nonprofit organizations and government agencies purchase or refinance properties and include the cost of repairs or improvements in the mortgage.

In March 1994, the Department made important refinements to the program. As a result of these refinements, there have been increases in both the number of 203(k) loans and the number of mortgage lenders making 203(k) loans. The 203(k) program has also made homeownership a reality for many homebuyers because it permits a greater maximum loan-to-value financing than other mortgage programs.

By using the 203(k) program together with CDBG, HOME and/or HOPE 3, the ability to provide affordable housing assistance to many low- and moderate-income families increases. 203(k) can expand the number of families assisted when it is combined with housing grant funds and provide a greater impact on neighborhood revitalization efforts. A community may use its grant funds to assist homebuyers with making downpayments, to pay some or all of the closing costs and/or to provide interest rate buydowns. Grant funds allow a community to fill a gap between the allowed 203(k) mortgage amount and the total cost of rehabilitation and acquisition of the property. These programs are designed to increase the number of low-income families and individuals who are able to purchase their own homes while revitalizing the neighborhoods in which they will reside.

: Distribution:

The CDBG program provides annual grants to states, metropolitan cities and urban counties to carry out a wide range of community development activities. Grantees must ensure that activities meet either community development needs having a particular urgency or one of the following national objectives: (1) benefit low- and moderate-income persons (80 percent or less of area median income); (2) aid in the prevention or elimination of slums or blighted neighborhoods.

HOME funds are allocated to states, local jurisdictions and consortia and can be used to provide assistance to homebuyers with annual incomes no greater than 80 percent of median income.

The HOPE 3 program provides homeownership opportunities to low-income families and individuals (80 percent or less of area median income) by giving grantees (private nonprofit organizations, public agencies in cooperation with nonprofit organizations, and cooperative associations) Federal assistance to acquire and rehabilitate single family properties owned by Federal, State and local governments and to finance the sale to eligible families at affordable prices. HOPE 3 grant recipients can also obtain 203(k) financing directly for acquisition and rehabilitation. After the loan is closed and the work is completed, a first-time homebuyer can assume the mortgage with no downpayment.

The 203(k) program is designed to promote partnerships among lenders, nonprofit organizations and government agencies. Lenders that are subject to the Community Reinvestment Act (CRA) and which participate in such partnerships will be able to better achieve their goals under the CRA by making more loans in low-and moderate-income neighborhoods.

BENEFITS TO NONPROFIT ORGANIZATIONS, GOVERNMENT AGENCIES, LENDERS AND HOMEBUYERS

Often the biggest barrier for a new homebuyer is not having sufficient funds for the downpayment and closing costs on the loan. State and local Governments are helping homebuyers with financial assistance, including lower interest loans, grants, interest rate buydowns, downpayment/closing cost assistance and equity investments on the property. Many potential homebuyers are able to make monthly mortgage payments but have not been able to save enough money to cover a standard downpayment and closing costs. State and local Government assistance to these potential homebuyers typically takes the form of providing all, or part of, the purchaser's required investment in the property or subsidizing the acquisition or rehabilitation of the property.

Another means of assisting such homebuyers is a lease/purchase. Government agencies or nonprofit developers will work with potential homebuyers to help them correct credit problems and to save for a downpayment. Some or all of the rent is earmarked for a future downpayment to permit the tenants to exercise their rights to purchase the units in the future. In many cases, the nonprofit developers provide downpayment assistance to the homebuyers.

When the nonprofit purchases a HUD-owned property, the downpayment could be as little as 3% (sometimes even less) of the purchase (bid) price of the HUD-owned property, with 100% financing of the costs of rehabilitation. Depending on the condition and location of the HUD-owned property being purchased, a nonprofit may be able to get a discount of between 10 and 30 percent. This discount is not given until sales closing and is reflected on the Form HUD 1, Settlement Statement.

A nonprofit organization may also purchase or refinance a property, rehabilitate it and allow a qualified homebuyer to assume the mortgage using the 203(k) Escrow Commitment Procedure. The nonprofit organization may have up to 36 months to complete the assumption process by entering into a lease/purchase agreement with the intended assumptor. A First Time Homebuyer may assume this mortgage for no downpayment.

A multifamily building may be reconfigured into a row house (townhouse) structure. This could be accomplished by changing the multifamily project into a Planned Unit Development (PUD), in which each unit is separately deeded. Each unit will be considered a one family dwelling for mortgage purposes. Units must be separated by at lease a one and one-half (1 1/2) hour firewall. By inserting such a firewall, previous multifamily buildings may also be divided into two, three, and four unit properties.

Departmental regulations restrict the number of rental units in which a non-profit or investor may have a simultaneous interest. In general, an investor-borrower may not have an interest in more than seven units (FHA, VA, FmHA, conventional, or free and clear) in the same subdivision or contiguous area. For 203(k) purposes, HUD defines a contiguous area as "within a two block radius." In addition, an investor should not be allowed to accumulate FHA insured properties that clearly and collectively constitute a multifamily project.

The seven unit limitation described above does not apply 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 revitalize the area.

Local HUD Office's may determine that the seven unit limitation is applicable in such redevelopment areas if:

A. The investor will own more than 10 percent of the housing units (regardless of financing type) in the designated area or sub-area; and,

B. The investor has more than eight units on adjacent lots.

Direct Endorsement lenders must submit requests in writing to the local HUD Office to waive the seven unit limitation stating the basis for the request. HUD Offices will then submit waiver requests to the Headquarter's Office of Insured Single Family Housing for approval. Waiver requests will only be approved in situations which do not represent a significant risk to the Department and in an area that is reasonably viable and with a demonstrated need for additional rental housing for families of low and moderate income.

Reasonable architectural and engineering fees and independent consultant fees may be included as a cost of rehabilitation. The following development fees may also be included in the cost of rehabilitation (allocated to each unit), provided they are reasonable and properly disclosed and accepted by the HUD Field Office prior to the issuance of the Statement of Appraised Value (form HUD 92800.5B) and the 203(k) Maximum Mortgage Worksheet (form HUD 92700): (1) Site acquisition and development costs; (2) Legal fees incurred in connection with the division of the property into separate units and the creation of homeowners' association; (3) Survey costs; (4) Common area landscaping, paving and maintenance fees; and (5) Project management fees. Other expenses (i.e., sales commissions and marketing expenses) may not be included in the mortgage and are the responsibility of the nonprofit organization.

HUD Homes (REO property) sold to a nonprofit organization or government agency at a 30% discount can only be resold to a person who intends to occupy the property as his or her principal residence and whose income is at or below 115 percent of the median income in the area, when adjusted for family size. In addition, the selling price of the property purchased from HUD cannot exceed the net development cost plus ten percent (10%). (Net development cost is the total cost of the project, including items such as acquisition cost (including the cost of rehabilitation), fees to prepare the work writeups and cost estimates, permits and survey expenses, insurance and taxes, excluding overhead and any developer's fee.) Basically, nonprofit organizations recoup their legitimate costs while, at the same time, keep the property affordable to the income level of their target buyers.

In another scenario, the nonprofit organization may decide to allow low-income borrowers to close the loan in their own names. In such cases; the nonprofit organization can obtain a Direct Endorsement Statement of Appraised Value (form HUD 92800.5B) from the lender in its own name by completing the construction exhibits and cost estimates. Prior to the Direct Endorsement lender issuing the Firm Commitment, a borrower can be qualified to purchase the home. At closing, the property may be deeded in the borrower's name.

When using the HOME program with 203(k), the funds may be subject to resale restrictions or recapture of funds for a certain period of time based on the level of subsidy invested. Resale or recapture provisions for HOME are developed by participating jurisdictions and approved by the HUD Office (Community Planning and Development Division).

However, Section 92.258 of the HOME rule requires that when HOME is used with HUD-insurance, the term of affordability must be as long as the mortgage term, which, in most cases will be longer than the maximum 15 year period of affordability. Participating jurisdictions will need to obtain waivers from HUD of this regulatory requirement if they wish to make the period of affordability consistent with the minimum HOME requirements.

If HOPE 3 funds are used to assist a homebuyer, a promissory note must be executed by the homebuyer when (1) either the purchase price for the property that is more than $4,000 below the after-rehabilitation fair market value, or (2) the homebuyer receives a non-repayable financing subsidy of more than $4,000 when purchasing and/or rehabilitating the property. The homebuyer may sell at any time after purchase, and is not required to sell to another low-income family. If the homebuyer elects to sell the unit to a non-low income person, the grantee has a first right of refusal to purchase the property for its fair market value.

A governmental agency may be approved by the local HUD Office to perform the home inspection, work writeup, cost estimate and the draw inspections on the property if its staff is qualified and trained for the 203(k) program.

EXAMPLES OF SUCCESSFUL PROGRAMS

A. The City of Rockford, Illinois, Community Development Department provides a Buy It/Fix It Program using the 203(k) program in conjunction with grants and deferred loans from its CDBG Funds.

To begin with, the City conducts a financial interview with the borrower to determine if he or she will qualify for the loan. When acceptable, the City's construction specialists do an inspection of the property and prepare the work writeup and cost estimate. In addition to this work, the construction specialists have also been authorized by HUD to make the draw inspections during the construction period. All these expenses are paid using CDBG funds.

The City is also responsible for preparing the closing documents for the CDBG portion of the loan. The CDBG funds are provided in the form of a deferred mortgage that is forgiven over 5 years for costs that exceed a percentage of the after-rehab value of the property [i.e., a "soft second" mortgage is forgiven incrementally over a 5 year period (if the borrower rehabilitates the property, then sells the property after 3 years, the repayment of the "soft second" will be reduced by 60%).

The CDBG funds are also used for the contingency reserve account, and if the contingency is not used, these funds are returned to the CDGB program. Persons of lower income may also receive 50% of the downpayment in the form of a grant using the CDBG funds.

CDBG funds and 203(k) insured mortgages are being used to redevelop and revitalize targeted areas of the community. As a result, the Buy It/Fix It Program can be used by potential homebuyers who will occupy the property (and also investors) to purchase and repair boarded, vacant and abandoned properties located within Rockford's target area. The following examples will illustrate how this Buy It/Fix It Program can be used, whether the borrower is going to occupy the property or have it available for rental purposes:

1. Owner-occupants

The homebuyer must agree to repair the property to FHA's standards (Handbook 4905.1, Requirements for Existing Housing) and the City of Rockford Building Code, and must reside in it for five (5) years. The homebuyer must be a U.S. citizen or registered alien, 18 years of age or older, and have a good credit history and be capable of supporting the cost of a loan. If the homebuyer meets established income guidelines, then the Buy It/Fix It Program may provide a grant for (1) 50% of the downpayment requirement, and (2) 50% of all closing costs. In addition, the City will provide a five-year forgivable loan for the project costs that exceed 80% of the after-rehab value of the property.

$15,000	Purchase Price
$35,000	Rehabilitation Cost
$50,000	Total Project Cost
$40,000	After-Rehab Value
$32,000	$40,000 X 80%

Subsidy Provided by City of Rockford

$50,000	Total Project Cost
$32,000	less 80% of After-Rehab Value
$18,000	City Grant Funds

(If the borrower's income exceeds the established income guidelines, then the percentage of After-Rehab value will be calculated at 85%. Properties for such borrowers must qualify under the CDBG national objective criteria for addressing slums or blight.)

2. Investors

The investor must provide a 15% downpayment and agree to repair and maintain the property to Section 8 Standards and City of Rockford Building Code for at least five (5) years. In addition, the rents for each property cannot exceed the Section 8 Fair Market Rents as established by the Housing Authority and 51% of the units must be made available to a low-income person or family. The City provides a five-year forgivable loan for the project costs which exceed 95% of the after-rehab value of the property. In the above example, the after-rehab value of $40,000 is multiplied by 95%, which equals $38,000; therefore, the amount of grant funds provided by the City will be $12,000.

B. The Columbus Housing Partnership (CHP), a non-profit organization associated with the Enterprise Foundation, has targeted some of its resources to help redevelop and revitalize particularly distressed inner city neighborhoods, with a goal to increase homeownership in these areas.

To help accomplish their affordable housing goals, CHP uses the 203(k program and the HOPE 3 grant program to purchase HUD Homes in these neighborhoods. CHP is able to buy a HUD Home at 10 to 30 percent less than HUD's asking price. When closing the loan with a 203(k) loan, the downpayment requirement is only 3 percent of the discounted price of the property and CHP gets 100 percent financing on the cost of rehabilitation.

The HUD Ohio State Office has allowed CHP to use its own staff to help its borrowers prepare the work writeups and cost estimates for the homes. As a result, CHP's construction manager meets with the family to discuss how the program works; in addition, an inspection of the property is made to identify the required items the borrower must repair.

To help market its community revitalization effort, CHP provides neighborhood based workshops and materials which explain the 203(k) program. This marketing activity helps consumers identify the 203(k) program as an effective tool for housing renovation and helps to improve the distressed neighborhoods.

The 203(k) loan is used with CHP's lease/purchase program, which allows more potential borrowers to start on the homeownership path. As a result, a family with minor credit problems is able to lease a renovated home until they qualify to assume the mortgage. In some cases, if the borrower is a first-time homebuyer, they can assume the mortgage with no downpayment, provided they can qualify to take over the mortgage payments.

C. The Denver Urban Renewal Authority (DURA) created a special affordable housing program to assist a very low-income family with income of only $1,176 per month.

The property was purchased by DURA and sold to the borrowers for $32,000. Rehabilitation costs to improve the property totalled $28,375. The total cost, including closing costs and prepaid expenses, amounted to $63,108.

It is obvious that a cost of $63,108 is far out of reach for a family with an income of $1,176 per month. However, through the structure of the DURA program, using the 203(k) program and several subsidy and grant programs, DURA was able to put this family into a newly rehabilitated home.

The first mortgage, insured by the FHA 203(k) program, was $32,100. The loan was sold to the Colorado Housing and Finance Authority under its Mortgage Revenue Bond program at a below market rate interest of 7.4%. Behind that loan, there is a second mortgage using HOPE 3 funds in the amount of $11,086. Behind that loan, there is a third mortgage from funding provided by the Federal Home Loan Bank of Topeka in the amount of $5,000. Further, there is a trust fund grant from the State of Colorado for $9,000, and another grant from the State of Colorado for $4,340.

As a result of this financing, the borrowers' cash investment from their own funds was $563 and their monthly payments are just $310 per month. In five years, their payments will increase to $362.58 when the monthly payment on the HOPE 3 loan begins.

SUMMARY

The Department believes that the 203(k) program can be a powerful tool for community revitalization and homeownership when combined with CDBG, HOME and HOPE III, which have a proven track record of assisting low- and moderate-income families. Working together, these programs can create affordable housing opportunities throughout the country. FHA lenders, state and local housing agencies and nonprofit organizations can demonstrate their commitment by working together to promote an expanded opportunity for homeownership.

If you have any questions concerning this letter, please call your local

HUD Field Office for information. Approval requirements for nonprofit organizations are in HUD Handbook 4155.1.

Sincerely,

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Assistant Secretary for Housing
Federal Housing Commissioner

Andrew M. Cuomo
Assistant Secretary for
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Development