

U.S. Department of Housing and Urban Development

District Office of the Inspector General
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July 15, 1996
Audit-Related Memorandum

96-AT-221-1823

MEMORANDUM FOR: Nicholas P. Retsinas, Assistant Secretary for Housing-Federal
Housing Commissioner, H

FROM: Kathryn Kuhl-Inclan
District Inspector General for Audit-Southeast/Caribbean, 4AGA

SUBJECT: Interim Report
Section 203(k) Rehabilitation
Home Mortgage Program

As you know, we are auditing the Section 203(k) Rehabilitation Mortgage Insurance Program. We have not completed our review. To date, however, our results show that extensive program abuse is occurring around the country by lenders, investors, and non-profits. The 203(k) Program, as currently designed, is too risky because it permits investors, non-profits, and lenders to walk away with big profits leaving HUD liable for the mortgages. The rehabilitation work is far from satisfactory. High claims and defaults are occurring on loans to investors and non-profits and seem likely to increase.

Before completing our audit, we would like to discuss with you our interim results and plans for further audit work. We will contact your staff to arrange a meeting.

Should you or your staff have any questions in the interim, please contact Nancy H. Cooper, Assistant District Inspector General for Audit, at (404) 331-3369, or Bruce Milligan, Senior Auditor, at (910) 547-4056.

SUMMARY

The 203(k) Program is highly vulnerable to waste, fraud, and abuse by investors and non-profit borrowers. The program design encourages risky property deals, land sale schemes, overstated property appraisals, and phony or excessive fees, and does not adequately safeguard HUD's interests. Moreover, participation by investors and non-profits does not appear to promote HUD's objective -- to restore and preserve existing housing in an effective, efficient, and economical manner. The abuses have not been isolated to any one person, group, or area of the country. As demonstrated by our examples, this program seems to be viewed by some as merely a means to turn a quick profit.

Our results show that investors and non-profit borrowers have carried out fraudulent or otherwise unnecessary land transactions to generate money for either the borrower or identity-of-interest (IOI) parties. They have not made required downpayments. They have obtained loans on properties which did not need significant repairs and should not have been in the program. Investors have been paid for rehabilitation work that was not performed. Non-profit borrowers have obtained large numbers of loans and have been unable to complete the work. Non-profit borrowers have also made large profits, contrary to their stated motivation. Unfortunately, mortgage lenders have contributed to the abuse. One large lender, for example, has repeatedly circumvented HUD loan origination requirements to assist otherwise unqualified borrowers in obtaining loans and has charged ineligible and unsupported fees.

The involvement of investors and non-profit organizations in the 203(k) Loan Program unnecessarily increases HUD's risk of loss to the insurance fund from defaults. Of the loans we reviewed, too few homes had been properly rehabilitated and timely occupied. In addition, we computed excessive profits and ineligible fees totaling about \$3.3 million in 291 loans -- a cost ultimately passed on to a homeowner or to HUD and the taxpayer in the case of a default. We believe that HUD should immediately disqualify investors just as it has done in the 203(b) Loan Program and take other precautions to prevent the program abuse that is occurring.

BACKGROUND

Section 203(k) loans were authorized by Section 101(c)(1) of the Housing and Community Development Amendments of 1978 (Public Law 95-557) which amended Section 203(k) of the National Housing Act. The program objective is to enable HUD to promote and facilitate the restoration and preservation of the Nation's existing housing stock. The 203(k) Program is regulated in Title 24 of the Code of Federal Regulations, part 203.50 and parts 203.440 through 203.495. Additional requirements are included in the 203(k) Handbook 4240.4 REV-2, ***Rehabilitation Home Mortgage Insurance***, and various Mortgagee Letters issued by HUD.

From October 1, 1985 through September 30, 1995, HUD endorsed for insurance 22,953 loans under 203(k), of which 20 percent were to investors and non-profits. The loans totaled about \$1.6 billion; \$674 million in 1995 alone. Recently, HUD began vigorously promoting the 203(k) Program. The number of loan originations increased significantly from an average of 437 in fiscal years 1986 through 1990, to an average of 3,093 in fiscal years 1991 through 1994, to a total of 8,391 in 1995. The projection for fiscal year 1996 is 15,000 loans. The claim/default rate for all 203(k) loans originated in the 8 year period ended December 31, 1995, was 5.1 percent for all types of borrowers. The rate for loans to investors and non-profits was 8.6 percent.

Section 203(k) loans are administered by the Office of Insured Single Family Housing within HUD's Office of Housing.

OBJECTIVES, SCOPE AND METHODOLOGY

Our objective is to determine if the 203(k) Rehabilitation Mortgage Insurance Program promotes and facilitates the restoration and preservation of existing housing in an effective, efficient, and economical manner. To date our review has included only loans to investor and non-profit borrowers. Our audit has generally covered the period July 1, 1993 through May 31, 1996.

The lenders and loans we reviewed are listed in Appendix A. We selected our sample to include loans throughout the country by high volume lenders made to borrowers obtaining multiple loans. Our sample included both current loans and loans in default. In some cases there were known problems in the origination of the loans when we made our selections and in some cases there were no known problems. At each lender, we interviewed key staff to determine the lender's administrative controls over the program. We reviewed the loan origination file for a sample of loans. On a test basis, we examined the closing agent's records and verified the receipt and disbursement of the funds at loan closing. In some cases we verified loan data with the borrower, the seller of the property, and the holder of any existing debt. We inspected a sample of the properties and examined the disbursement records for the rehabilitation escrow account and supporting documentation. We are in the process of determining if the properties are occupied by a homeowner or lessee and the mortgage status of the loans. All samples were judgmentally selected.

We also reviewed reports of monitoring work for the 203(k) Program performed by the HUD Office of Lender Activities. These reviews are also listed in Appendix A.

We began the audit on June 29, 1995.

INTERIM RESULTS

LOANS TO INVESTORS AND NON-PROFITS CONSTITUTE UNREASONABLE RISK

Section 203(k) loans to investors and non-profit organizations constitute unreasonable risk to the FHA insurance fund. Our results show that these types of borrowers have obtained HUD-insured loans which fail to meet HUD requirements, fail to meet prudent lending practices, and are clear indications of program abuse. We identified:

- △ Land sale schemes intended to turn quick profits between IOI parties.
- △ Borrowers failing to make downpayments necessary to guarantee their commitment.
- △ Rehabilitation work not completed or improperly performed.
- △ Properties overvalued at "after rehab" values.
- △ Profits to non-profit organizations.
- △ Rehabilitation loans made on properties which needed only minor maintenance.
- △ Higher loan defaults and forced refinances.
- △ Ineligible and unsupported fees.

These cases are not isolated. Together with the results from Lender Activities, our reviews span the activities of 73 investors and non-profits receiving 449 loans from 6 different lenders throughout 8 states. Unless some immediate action is taken, we predict substantial future losses to the FHA fund from or because of these types of borrowers.

(Hard copy contains graphic of number and location of loans reviewed)

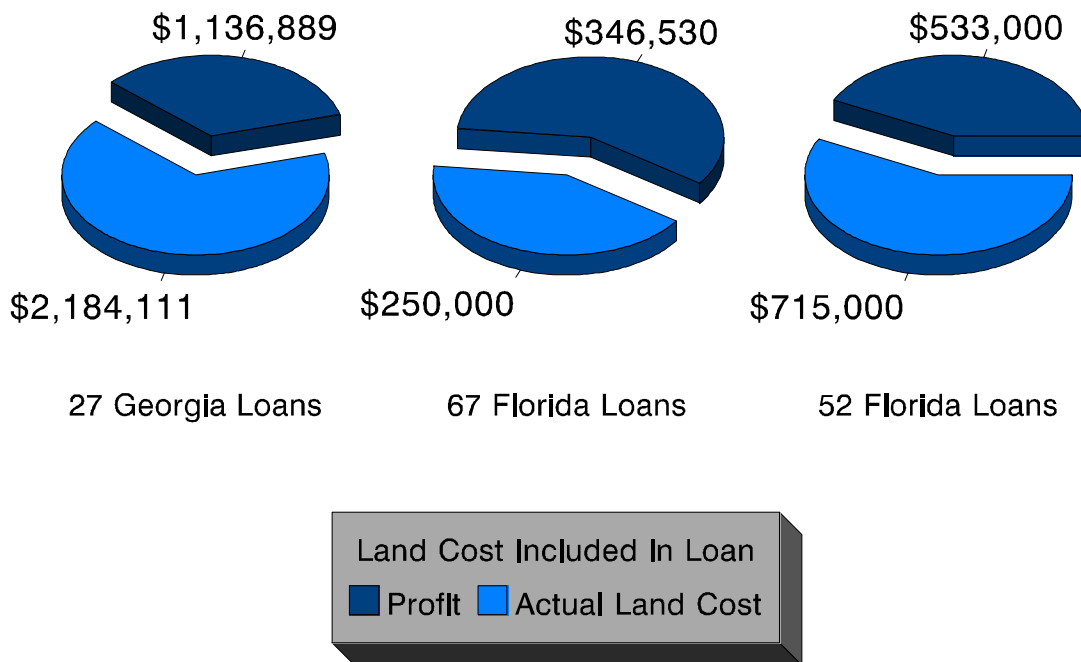
WIDESPREAD PROGRAM ABUSE

This interim report describes cases of fraud and program abuse by investors and non-profit borrowers participating in the 203(k) Program. Our results coincide with results of reviews being conducted by the Office of Lender Activities. Our work in process, not described in this report, continues to show more evidence of fraud schemes and abuse.

Land sale schemes - Borrowers on 27 loans in Georgia, 119 loans in Florida, and still others in Virginia and California have participated in fraudulent and unnecessary land transactions for the sole purpose of generating immediate cash profits for either the borrower or IOI parties. The schemes are netting the parties millions of dollars with no value added while unnecessarily putting HUD at risk. The parties inflate property sales prices which increase the loan amounts. This allows the borrower to realize profits at loan closing instead of after the property is repaired and sold. It also takes away the borrower's incentive to ensure the rehabilitation is properly completed.

The following chart illustrates the exorbitant profits made on property deals in Georgia and Florida.

Profits in Land Sales Schemes



Details of these land sales schemes follow:

- An investor purchased and immediately sold 27 properties in Georgia turning a quick and illegal profit of over \$1 million. The loans were closed in Virginia and, according to HUD's Virginia Office, the price paid by the borrower could not exceed the price paid by the seller if the seller had acquired the properties within 1 year of the closing of the HUD-insured loans. In this case, the investor had acquired 23 properties on the same day of closing the 203(k) loans and within 3 months of closing the others. Therefore, the investor, who had an IOI with at least 19 and possibly all of the 27 borrowers, falsified the HUD-1 Settlement Statement to show that it had paid \$123,000 for each of the properties. The investor actually paid \$80,893 per property and took a profit of \$1,136,889 with minimal investment or risk. This scheme increased HUD's risk by \$35,800 per property. The four individuals in this investor partnership agreed to a 5 year suspension from doing business with HUD.

- For 67 loans in Florida, a lender, a non-profit borrower, and another non-profit group represented by an official of the rehabilitation contractor, joined in a phony land transaction which unnecessarily increased the HUD-insured loans by about \$328,000. The HUD-1's showed the non-profit borrower paid the non-profit group \$596,530 for the properties. Each HUD-1 was falsified. At the time, the borrower had already agreed to purchase the properties from the Federal Home Loan Mortgage Corporation (Freddie Mac) for only \$250,000. At closing, loan proceeds of \$219,573 (sales price of \$250,000 less downpayment and settlement charges) were actually paid to Freddie Mac and nothing was paid to the non-profit group. As the following chart shows, the borrower did not make the required downpayment (falsely stated as \$167,098) and the lender took \$179,432 in cash at closing.¹

HUD-1 PART	DESCRIPTION	PER HUD-1's	PER CLOSING AGENT RECORDS	PER HUD RULES ²
101	Contract Sales Price	\$596,530	\$250,000	\$250,000
103	Settlement Charges to Borrower	\$1,574,812	\$1,574,812	\$1,574,812
120	Gross Amount Due From Borrower	\$2,171,342	\$1,824,812	\$1,824,812
202	Principal Amount of New Loan	\$2,001,250	\$2,001,250	\$1,654,720
207	Prepaid Interest Credit	\$2,994	\$2,994	\$2,994
220	Total Paid By/For Borrower	\$2,004,244	\$2,004,244	\$1,657,714
303	Cash From Borrower	\$167,098		\$167,098
	Cash To Borrower		\$179,432	

- Another non-profit borrower bought 52 properties through the same lender in Florida for \$1,248,000, netting the seller a profit of \$533,000. The seller, who had been disapproved by HUD to participate in this program, had acquired the properties on or about the same day for \$715,000. Contrary to HUD requirements, the president of the non-profit borrower also served as the closing agent for the HUD-insured loans. About 4 weeks after closing, the borrower deeded the 52 properties back to the seller. About 2 weeks after that and without HUD approval, the lender filed a document releasing the borrower from liability for the mortgages. A week after that, the borrower deeded the 52 properties back to the seller. We are continuing our review of these loans plus another 14 which appear to involve similar transactions.

Borrower downpayments not made - Despite the borrowers' signed statements to the contrary, we documented 90 loans where investors and non-profit borrowers have not made downpayments as required. When a borrower has no investment at risk, HUD's risk becomes greater.

¹ See Audit Report 96-AT-221-1004, Waters Mortgage Corporation, dated May 13, 1996, for additional information.

² This column shows how the loan should have been closed following HUD requirements.

The following are examples:

- A non-profit borrower failed to make downpayments on 79 Florida loans totaling \$198,767.
- An investor in North Carolina did not make downpayments of \$44,000 on six loans from its own resources. Instead, the father of the seller of the property put up \$44,000 for the borrower's downpayments.
- An investor in Georgia obtained five loans to refinance existing debt and rehabilitate the properties. At loan closing, proceeds of \$15,789, which were supposed to be used to pay off the borrower's existing debt, were instead used for the borrower's downpayments.

Rehabilitation work not properly performed - In 149 cases, investor and non-profit borrowers have failed to properly complete the rehabilitation work funded by the 203(k) loans. Some non-profits have attempted to restore too many properties at once. Lenders, whose responsibility it is to ensure timely and proper completion of rehab, have also failed to perform. The probability of loan default greatly increases when rehabilitation work stalls.

Listed are some of the cases found:

- For 43 loans in Illinois, a lender certified that the rehabilitation work was completed and released the rehabilitation escrow funds. Office of Lender Activities subsequently determined that, for 12 properties, little or no work was performed. For the rest, substantial portions of the scheduled work had not been performed.

- An investor obtained five loans in Georgia in December 1994 but did not complete the property rehabilitation. The lender disbursed \$10,800 from the rehabilitation escrow for work which was certified as completed. We confirmed that it was never performed. The loans went into default after only four mortgage payments. The two pictures below show the condition of these properties as of April 1996. (Hard copy contains two photos.)
- The next two pictures are of multi-unit properties abandoned by an investor in North Carolina who did not complete the rehabilitation. He defaulted on the six loans after making only six payments. The borrower tried to perform as the general contractor but apparently did not have the capability to complete the job. The loans on the 6 properties closed in the fall of 1993. These pictures were taken in March 1996. (Hard copy contains two photos.)
- A non-profit borrower in Florida had loans for 107 properties under rehabilitation at one time. The borrower failed to timely complete the rehabilitation work for 95 properties and the loans went into default. We believe the borrower lacked the managerial capability. The files showed the borrower did not have the financial capacity to carry the loans. So, the borrower transferred the 95 properties to a second non-profit borrower. The second borrower assumed 51 of the loans but obtained new 203(k) loans for the other 44. The 44 new loans included more money for rehab and exceeded the original loans by \$218,500. Over 23 months after closing these 95 loans, the rehabilitation of 40 properties was still not complete.

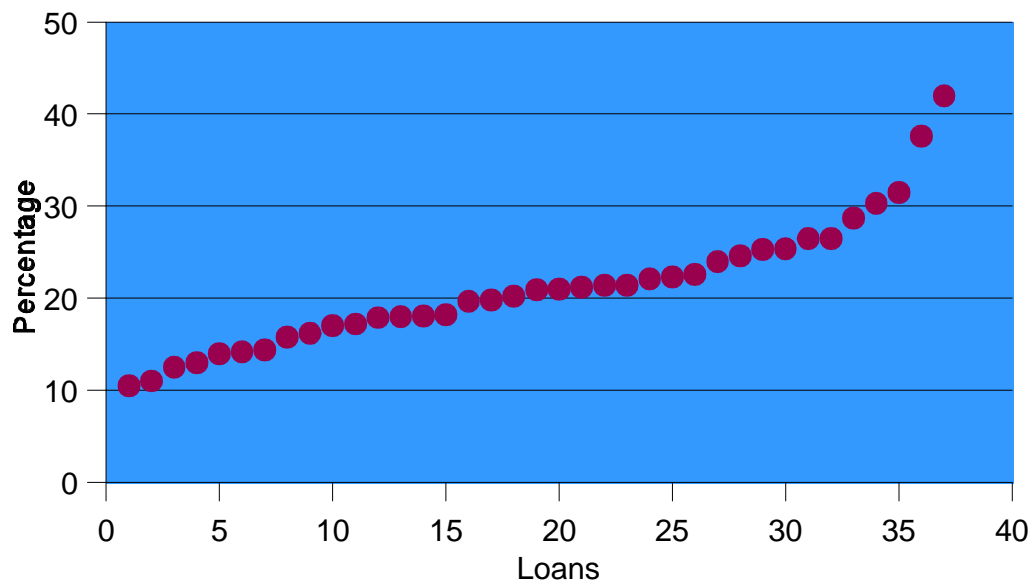
Properties were overvalued - The Office of Lender Activities reviewed 61 loans in Illinois and found that the appraised value of 50 of the properties was substantially overstated. The overstatements ranged from \$5,500 to \$71,000 and averaged \$24,520. The loans were inflated to provide excess rehabilitation escrow funds which the lender then disbursed for work which was not performed.

Overstated appraisals increase HUD's risk from defaults because the higher loans make it more difficult for borrowers to sell the properties by assumption or to lease them at high enough rents to pay the note. Overstated appraisals facilitate the land sale schemes, excessive rehabilitation, and unnecessary fees.

Excess profits by non-profit borrowers - Some loans included what we considered to be excessive profits for non-profit borrowers. Through the 203(k) escrow commitment procedure, loans may include amounts set aside as profit for the borrower. The escrow is released to the borrower after the property is rehabilitated and transferred to a new buyer. These profits increase HUD's risk by raising the loan amount and the cost of the housing.

We found several examples of generous profits to non-profit borrowers:

- A non-profit borrower in Texas obtained 37 loans between April and September 1995. The loans included escrow commitments of \$533,250, an average of \$14,412 per loan. As the chart illustrates, the average commitment was 21 percent of the loan amount; the highest commitment was 42 percent of the loan total. The escrow commitment amounts almost equaled the cost for rehab.



● Percent of Loan Proceeds Used for Escrow Commitment

- In Georgia, a non-profit borrower obtained 21 loans from March through August 1995. Fifteen of the loans included escrow commitments totaling \$99,850. The commitments for 10 of the loans exceeded 10 percent of the loan amount, averaged 18 percent, and ranged from 10.5 to 29.4 percent.
- A non-profit borrower in Illinois obtained 13 loans in March 1995. The loans included escrow commitments totaling \$98,427, the highest being 28.5 percent of the loan amount.

Significant rehabilitation not needed - Investor and non-profit borrowers have obtained 203(k) loans on properties that did not need significant rehabilitation. Some properties barely qualified. These loans increase HUD's risk and do nothing to meet the program objective to improve the Nation's existing housing stock.

- In Georgia, an investor's rehabilitation of 24 properties, all duplex units, averaged only \$6,287 and ranged from \$5,744 to \$6,798. This barely exceeded the program minimum of \$5,000. Inspections and interviews of occupants of a sample of units revealed that (1) much of the work in the write-ups appeared unnecessary, (2) some work was over priced, and (3) some work planned was not completed. The units are part of the 27 loans previously described where the seller inflated the sales prices by \$1,136,889. We concluded that the units did not need rehabilitation at all and were in the program solely to enable the seller to profit on the land sale transactions.
- A citizen has complained of loans made on units in Houston, Texas which did not need significant rehabilitation work. We have begun a review of these loans.

Ineligible and unsupported fees included in the loans - On 95 loans in Florida, a lender claimed \$25,075 in ineligible and unsupported fees. The lender also approved \$15,364 in ineligible fees to be paid to the borrower.

REASONS FOR PROGRAM ABUSE

The 203(k) program is vulnerable to program abuse from investor and non-profit borrowers for several reasons.

Profit Motive - Investors participate for the profit. The prospects of substantial returns lead some to commit fraud. HUD experienced problems with investors participating in the Single Family Mortgage Insurance Program and in December 1989 prohibited them from obtaining most HUD-insured single family loans. HUD did not apply the prohibition to the 203(k) loan program. It also appears that some non-profit borrowers do not have as their primary objective the goal of serving low and moderate income families or of community revitalization. Instead, they have committed the same abuses as investors to generate profits for themselves.

Program design flaws - The design of the 203(k) Program is risky with incentives and opportunities for abuse. Although small in volume compared to HUD's 203(b) Single Family Program, these loans represent a significant risk to HUD.

1. HUD relies heavily on the lenders to ensure loans are originated according to program requirements, yet the prospect of earning the large fees allowed by this program can and has enticed lenders to break the rules. All loans we reviewed were originated by direct endorsement. In many cases, the lenders performed the work write-up and cost estimate, appraisal, and rehabilitation inspections with in-house staff. This earned the lender fees and allowed it control over most of the loan processing steps. These loans also include higher interest rates and origination fees than HUD's 203(b) loans. In some of our cases, the lenders approved loans even though they knew or should have known the loans did not meet HUD requirements.
2. A 203(k) loan can be as high as 110 percent of the after rehabilitation appraised value. A property encumbered by a loan that exceeds the property's value is more difficult for an investor or non-profit borrower to rent or sell by loan assumption. Thus, HUD's risk of loss increases.
3. The program allows the borrower to serve as the general rehabilitation contractor. Some borrowers did not appear to have the skills needed to perform in that capacity.
4. As described in Appendix B, there are many steps in the 203(k) loan process. Many are critical and must be properly performed for a successful loan. Failure in any one area can result in a loan default.
5. HUD's Office of Insured Single Family Housing does not obtain default data on 203(k) investor and non-profit borrower loans. However, we obtained data which shows that the rate is 8.6 percent for loans originated in the 8 years ended December 31, 1995. This is 3.5 percent higher than the overall rate for the 203(k) Program and about 5.5 percent higher than the 203(b) Program. It is also likely that the 203(k) default rate is understated because (1) there has been a large increase in the number of loans originated in 1995, and (2) loans are being refinanced as new 203(k) loans or as 203(b) loans. Without analysis of that data, HUD cannot truthfully evaluate the overall performance of the program or target individual lenders or borrowers for review.

STEPS HUD HAS TAKEN

The Office of Housing has recently taken steps to strengthen program controls to prevent some of the abuses we and they have seen. In Mortgagee Letter 95-40 dated September 13, 1995, HUD added procedures designed to (1) prevent land sales schemes (2) require HUD approval of non-profit borrowers, and (3) improve the lender's review of the financial capacity of non-profit borrowers. Also, the Office of Lender Activities has reviewed several lenders to document program abuses and recommended sanctions to the Mortgagee Review Board. The Board has imposed sanctions against two lenders; sanctions are pending against two more.

The Office of Housing has performed significant program monitoring. However, HUD does not have enough staff to detect and correct program abuses to the extent we noted in our audit. Given the vulnerabilities of the program, we strongly believe abuses by investor and non-profit lenders will continue and become even more widespread unless more program changes are made.

RECOMMENDATIONS

We offer the following recommendations for your consideration.

- 1A. Prohibit investor participation as HUD has previously done in other single family mortgage insurance programs.

- 1B. Monitor the effectiveness of the new procedures for HUD approval of non-profit borrowers and lender review of the non-profit borrowers' financial capacity. If the new procedures are ineffective, then HUD should not allow direct endorsement of loans to non-profit borrowers.
- 1C. Take further steps to prevent land sales schemes such as:
- Require an "as-is" appraisal for projects involving over seven loans.
 - Require the borrower to certify, over a warning notice, the interest of any identity-of-interest party in the seller of the property.
 - As part of the title process, require the lender to determine the chain of ownership of the property for 2 years prior to the loan to identify identity-of-interest transactions.
 - Require the lender to verify that the loan proceeds are disbursed in the proper amount to the property owner included on the loan application, or in the case of a refinance transaction, to the debt holder.
- 1D. Increase the minimum amount of rehabilitation work required to an amount such as the greater of \$10,000 or 10 percent of the loan amount.
- 1E. For loans to non-profit borrowers, limit the amount of their reimbursement for overhead and profit. Alternatives might be to (1) limit the escrow commitment (amount of potential profit) to a reasonable level, such as 5 percent of the loan, or (2) eliminate the escrow commitment procedure and allow a fixed fee.
- 1F. Prohibit the borrower from acting as the general contractor unless the borrower can demonstrate sufficient construction experience.
- 1G. Issue a Mortgagee Letter warning lenders of the program abuses that have been found, the penalties which may be imposed for such abuses, and HUD's intention to impose sanctions and refer abusers for criminal prosecution.
- 1H. Obtain claim/default data by borrower type to use in evaluating the program's effectiveness and for targeting lenders for compliance reviews.

Schedule of Work Completed and in Process

We have substantially completed reviews of the following lenders and loans:

<u>Lender</u>	<u>Borrowers</u>	<u>Loans Reviewed</u>	
		<u>Location</u>	<u>Number</u>
Directors Mortgage Loan Corporation	11 Investors	Georgia	27
Unity Mortgage Corporation	1 Investor	Georgia	5
Tidewater First Financial Group Inc.	1 Investor	N. Carolina	6
Waters Mortgage Corporation	1 Non-profit	Florida	107
Total loans reviewed			<u>145</u>

We have started reviews of the following lenders and loans:

<u>Lender</u>	<u>Borrowers</u>	<u>Loans Reviewed</u>	
		<u>Location</u>	<u>Number</u>
FT Mortgage Companies	1 Investor	Massachusetts	8
Waters Mortgage Corporation	1 Non-profit	Florida	66
Waters Mortgage Corporation	1 Non-profit	Georgia	21
Waters Mortgage Corporation	1 Non-profit	Texas	37
Waters Mortgage Corporation	1 Non-profit	Illinois	13
Total loan reviews in progress			<u>145</u>

We have also reviewed the results of monitoring reviews of the HUD Office of Lender Activities for the following lenders and loans:

<u>Lender</u>	<u>Borrowers</u>	<u>Loans Reviewed</u>	
		<u>Location</u>	<u>Number</u>
Directors Mortgage Loan Corporation	4 Investors	Virginia	28
FT Mortgage Companies d/b/a Carl I. Brown Company	46 Investors	Illinois	93
FT Mortgage Companies d/b/a Carl I. Brown Company	1 Non-profit	California	21
Bankers Surety Association	3 Investors	California	17
Total Lender Activities reviews			<u>159</u>

Summary of 203(k) Program Procedures

Following is a summary of how the 203(k) Program works.

The program can be used to rehabilitate dwellings in one of three ways: (1) purchase a dwelling and the land on which the dwelling is located, (2) purchase a dwelling on another site and move it onto a foundation on the mortgaged property, and (3) refinance existing indebtedness. Eligible properties include one to four family dwellings that have been completed for at least one year and homes that have been demolished or need to be razed if the existing foundation system is not effected and will be used. A one family dwelling can be converted to a two to four family dwelling or a multi-unit dwelling can be decreased to a one to four family unit; and a property that is used for residential and commercial purposes may be eligible under certain circumstances.

The potential borrower locates an eligible property. The borrower submits an application to a lender and enters into a sales contract that is contingent upon 203(k) loan approval and the borrower's acceptance of any additional required improvements as determined by HUD or the lender.

Either the borrower or a consultant prepares a work write-up and cost estimate. The rehabilitation must include at least \$5,000 of eligible improvements on the existing structure on the property. Any repair is acceptable in the first \$5,000 requirement that may affect the health and safety of the occupants. Minor or cosmetic repairs by themselves cannot be included in the first \$5,000, but may be added after the \$5,000 threshold is reached. Following the lender's acceptance of the work write-up and cost estimate, the lender requests assignment of a HUD case number. A plan reviewer meets with the borrower and contractor at the property to ensure that the work write-up and cost estimate are acceptable and all program requirements are met. A written appraisal is prepared of the expected property market value after rehabilitation work is completed. In some cases, an as-is appraisal is also required.

The lender reviews the application and the appraisal to determine the maximum insurable mortgage amount for the property. The mortgage amount is limited to the loan-to-value ratio and maximum dollar amount that apply to similar properties under Section 203(b). The value of the maximum mortgage calculation is based on the lesser of (1) as-is value of property plus rehabilitation costs or (2) 110 percent of the expected property market value after rehabilitation work is completed. The as-is value of the property is usually based on the borrower's purchase price, or for refinance cases, an as-is appraisal. The rehabilitation cost can include up to six mortgage payments to assist the borrower when the property is not occupied during rehabilitation. The maximum mortgage amount for owner occupants and non-profit borrowers is based on 97/95 percent of the maximum mortgage calculation. The maximum mortgage amount is based on 85 percent of the maximum mortgage calculation if the property is purchased for investment purposes. The lender completes a review of the borrower's credit and ability to repay the loan.

The 203(k) loan is then closed and the lender submits copies of the mortgage documents to HUD for review. If documents are found acceptable, HUD issues a Mortgage Insurance Certificate to the lender.

The borrower then has up to six months to complete the rehabilitation work. As the rehabilitation work progresses, funds are released from the rehabilitation escrow account after the work is inspected by a HUD approved inspector. Any unused funds in the rehabilitation escrow account are applied to the mortgage. If the escrow commitment procedure is used, the lender continues to administer the escrow account (see Appendix C).

Escrow Commitment Procedure

The purpose of the 203(k) Program's escrow commitment procedure is to encourage program participation by investor and non-profit borrowers. The procedure allows the investor or non-profit borrower to sell the property, after the rehabilitation work is completed, to a buyer who assumes the 203(k) loan without the cost of a new loan. The procedure makes it easier for the borrower to sell the property and thus, increases the borrower's chance of making a profit.

Under the escrow commitment procedure, an investor borrower who purchases an investment property but intends to sell the rehabilitated property to a mortgagor acceptable to HUD, can qualify for a mortgage based on the market value of the property after rehabilitation. The difference between the downpayment requirements for an owner-occupant and an investor is retained in an escrow account.

If the property is sold prior to the 18th amortization payment of the mortgage, the escrow amount is paid to the borrower. If the property is not sold by the 18th payment, the escrow amount must be applied to reduce the mortgage amount to an amount available for an investment property.

A first time homebuyer can assume the mortgage for no downpayment. An owner-occupant who is not a first time homebuyer must provide a downpayment. Another investor can assume the loan by making a 15 percent downpayment. If the resale price is less than the appraised value of the property, the mortgage amount must be reduced so that the purchaser maintains a minimum downpayment based on the acquisition price. If the resale price is greater than the appraised value, the purchaser must make a larger downpayment.

Following is an example of the escrow commitment procedure. Assume an investor borrower can purchase a property for \$50,000 and the cost of rehabilitation will be \$20,000. The borrower will have to make a 15 percent downpayment (\$10,500) on the acquisition cost of \$70,000 (\$50,000 + \$20,000). If the after-rehab appraisal shows the market value of the property will be \$100,000 after the completion of the rehabilitation, then the mortgage for an owner-occupant who will assume the loan will be \$95,500. The borrower will apply \$10,500 to the escrow account and the loan proceeds will provide \$25,500 (\$95,500-\$70,000). When the loan is assumed by a qualified borrower, the total amount of \$36,000 in the escrow commitment account will be released to the investor borrower. A first time homebuyer could assume the mortgage for no downpayment.

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