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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

March 3, 1997

MORTGAGEE LETTER 97-5

TO: ALL APPROVED MORTGAGEES

SUBJECT: Single Family Loan Production-Revised Escrow Commitment Procedure-Section 203(k) Rehabilitation Mortgage Insurance Program

This Mortgagee Letter is to advise you that the Department has revised the Section 203(k) Escrow Commitment Procedure.

The language in Section 203(k)(3)(A) of the National Housing Act states: ". . . the Secretary shall establish as the appraised value of the property an amount not to exceed the sum of the estimated cost of rehabilitation and the Secretary's estimate of the value of the property before rehabilitation." Therefore, since the value of the property is limited to the "as-is" value of the property plus the cost of rehabilitation, the mortgage can not be based on the "after-improved" value (when it exceeds the as-is value plus cost of rehabilitation).

As an example, assume the sales price (and as-is value) of the property is $50,000 and the cost of rehabilitation is $20,000, then the mortgage basis cannot exceed $70,000. However, if the after-improved value of the property is less than the acquisition cost of $70,000, then the mortgage basis cannot exceed the lesser of (1) the as-is value plus cost of rehabilitation or (2) 110% of the after-improved value of the property. (Refer to the 203(k) Maximum Mortgage Worksheet (form HUD 92700) for additional information on calculating the maximum mortgage. When using the 203(k) Maximum Mortgage Worksheet, Section E will no longer apply).

To phase into the revised procedure and to allow mortgage lenders to clear up their current pipelines, sales contracts involving applications in the possession of the mortgage lender prior to the date of this letter may be processed under the guidelines in effect prior to this letter. The mortgage lender must approve such applications within 30 days of the date of this letter. Applications received by the lender on or after the date of this letter must comply with this revised policy.

This revision in no way prohibits borrowers from allowing the assumption of the mortgage by a qualified buyer. However, it does change the process for calculating the mortgage amount. It eliminates the ability to close a mortgage with an amount greater than the "as-is" value of the property plus the cost of rehabilitation (i.e., the amount that will be held in escrow). In addition, the borrower will no longer be able to establish an escrow account for mortgage funds exceeding the acquisition cost of the property, less the borrowers cash investment at closing.

Where the property's value is greater than the mortgage amount, the mortgagor may sell the property to a qualified borrower after the rehabilitation is complete by using the Section 203(b) program. As a reminder, non-profit borrowers are allowed to provide a gift for the cash investment in the property to assist a low- or moderate-income family or a first-time homebuyer in obtaining a new FHA insured mortgage. See paragraph 2-10.C of the Mortgage Credit Analysis Handbook (HUD 4155.1 Rev 4, Change 1).

Under HUD's REO Discount Sales Program, it is possible under certain circumstances for a non-profit or government entity to receive up to a 30 percent discount on the sales price of a property. HUD's intent is for those buyers receiving a discount off the sales price in excess of 15 percent to perform necessary repairs and resell the property to individuals/families who intend to occupy and whose income does not exceed 115 percent of the median income for the area, when adjusted for family size. The resale price of the property cannot exceed 110 percent of the net development cost. Lenders should expect to receive a Land Use Restriction Addendum with the REO Sales Contract, which specifies the obligations of the buyer on properties purchased at a discount in excess of 15 percent.

The net development cost is defined as the total cost of the project, including items such as acquisition cost, architectural fees, permits and survey expenses, insurance, rehabilitation, and taxes (for a 203(k) loan, use lines A-1 and B-14 of the 203(k) Maximum Mortgage Worksheet, form HUD 92700). Total costs incurred by the purchaser, including those for acquisition financing, management fees and selling expenses related to the project can also be included, but are expected to be reasonable and customary for the area in which the property is located. The purchaser can also include up to three months' mortgage payments (principal and interest only), less all rents received. The net development cost cannot include gifts to the eventual purchaser for the down payment, financing or closing costs, nor any other related expenses associated with that buyer's purchase of the property.

The lender is responsible for analyzing the closing documents to assure the non- profit or government entity is not making in excess of a 10 percent profit and that the borrower's income does not exceed 115 percent of median income. If the sales price exceeds 110 percent of the net development cost, then the excess profit must be used to pay down the existing mortgage. Supporting documentation must be reviewed by the underwriter prior to closing the loan. The lender is not required to recalculate the profit if the non-profit or government entity sells the house on a new loan that the lender does not originate (since the lender is not in control of the new loan); however, it is the non- profit or government entities' responsibility to make sure they are in full compliance with all HUD requirements. The profit on the sale of one property cannot be offset by the lesser profit or loss on another property.

The property may not be occupied by or resold to any of the non-profits' officers, directors, elected or appointed officials, employees, or the spouse, child, stepchild, parent, step-parent or business associate of any of the above. There may not be a conflict-of-interest with individuals or firms that may provide acquisition or rehabilitation funding, management or sales services, or other services associated with the property.

The Department will be making additional changes in the future to strengthen the Section 203(k) program. We are currently reviewing recommendations by the 203(k) Working Groups and hope to have the revisions implemented in the Spring.

If you have any questions concerning the changes to the 203(k) Escrow Commitment Procedure, please contact your local HUD Office.

Sincerely,

Nicolas P. Retsinas
Assistant Secretary for Housing-
Federal Housing Commissioner