

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

February 24, 1998

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

MORTGAGEE LETTER 98-11

TO: ALL APPROVED MORTGAGEES

SUBJECT: Single Family Loan Production - Concerns about 203(k)
Underwriting, Loan Processing and Administration

The purpose of this Mortgagee Letter is to emphasize the Department's concerns that Direct Endorsement lenders strictly observe the underwriting guidelines of @ Handbooks 4155.1 REV-1 and 4240.4 REV-2, exercise care in assuring the accuracy of 203(k) loan data entered in the CHUMS system, and conduct more active oversight of construction progress and contractor performance.

HUD's Office of Inspector General recently audited a random sample of 203(k) loans made to owner occupant borrowers nationwide. While generally favorable, the draft audit report cited a number of problems which continue to raise Departmental concerns about the insurance risks of home improvement loans. The problems included questionable loan origination decisions, excessive data entry errors in coding the loans in the CHUMS system, and less than effective administration of the rehabilitation process. To help mitigate these concerns, lenders must assure that staff underwriters are properly trained in using the 203(k) program and strictly follow FHA guidelines. Lenders should also take specific steps to improve quality control over data entry and comply with the loan administration directives of this Mortgagee Letter.

1. 203(k) Loan Underwriting.

Lenders must strictly observe FHA underwriting guidelines when approving 203(k) loan applications. Underwriting decisions questioned by the Inspector General included approving loans for home improvements on a vacation property and for work items that did not meet the \$5,000 minimum threshold for loan eligibility. Lenders are reminded that, when underwriting 203(k) loans, the compliance tests for loan endorsement must be met. The Department may require indemnity in egregious cases and/or report abuses to the Office of Lender Activities and Program Compliance for review and to the Mortgagee Review Board (See Mortgagee Letter 97-45).

2. Data Entry in CHUMS.

Lenders must improve the accuracy of loan data entered in the CHUMS system. The Inspector General tested 82 randomly selected 203(k) loans closed in FY 1996 and coded as owner occupant borrowers. Twenty-eight of the loans (34%) were actually made to

investors or non-profits, as evidenced in the loan documents. Error rates of this magnitude significantly reduce the Department's ability to effectively monitor or accurately report portfolio performance. Lenders should have quality controls in place to assure data entry is done properly. Five codes are available in CHUMS to describe "borrower type." The first code, occupant, should never be appropriate for investor or non-profit borrowers. Departmental staff will monitor CHUMS input for compliance.

3. 203(k) Loan Administration

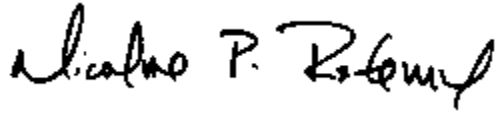
Lenders need to play a more active role in assuring construction work progresses on schedule and workmanship is acceptable. The Inspector General noted that lenders released loan proceeds to pay contractors when some of the rehabilitation work was incomplete or not done to standards. While concerns about timely and quality construction work are not new to home improvement contracts, the Department believes lenders can be a more effective control over contractor performance. Lenders should not close 203(k) loans before approving an acceptable general contractor when borrowers want the work done on contract. Lenders are also encouraged to intercede early in disagreements between borrowers and contractors. Complaints to the Department suggest that misunderstandings of work scope and the absence of written agreements to changes often contributed to subsequent disputes and construction delays. Therefore, it is imperative that borrowers and contractors complete a Homeowner/Contractor Agreement (See Mortgagee Letter 94-11 , Attachment 5). The Agreement must include a provision for binding arbitration when construction disputes cannot be resolved through lender intercession.

Lenders should make sure borrowers, who elect to do their own work, have the time and expertise to complete the rehabilitation work on schedule. The Inspector General found that borrowers often did not complete the work within the lender's or the Department's required time constraints. Borrowers doing their own work must have lender approval, sign a self-help agreement, and fully understand that construction must be completed within six months of loan closing or a shorter period, as determined by the lender.

Lenders also need to improve control over fund disbursements. The Inspector General found checks issued solely to the borrower, not the contractor as co-payee, when the contractor requested payment. Lenders also issued checks to borrowers, who were approved to do the construction themselves, without documented receipts of actual costs. Borrowers are not eligible for reimbursement of "sweat equity" under 203(k) guidelines, as discussed in Mortgagee Letter 94-11 and stated in the borrower's Self-Help Agreement. Therefore, lenders should instruct borrowers that, as general contractors, they must maintain complete records showing the actual cost of rehabilitation. Documentation of actual costs means paid receipts and lien waivers from subcontractors. The lender should assure the adequacy of the borrower's records through periodic requests for documentation of money spent on materials and/or the project as a whole.

If you have any questions concerning the content of this Mortgagee Letter, please contact your local HUD Office. If you are aware of any fraud in HUD programs, report the matter by calling your nearest HUD Office or the HUD Regional Inspector General. You may also call the HUD Hotline at 1-800-347-3735 or 202-708-2451.

Sincerely,

A handwritten signature in black ink that reads "Nicolas P. Retsinas". The signature is written in a cursive style with a large initial 'N'.

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