CHAPTER 1. GENERAL INFORMATION

1-1. INTRODUCTION. Section 101(c)(1) of the Housing and Community Development Amendments of 1978 (Public Law 95-557) amends Section 203(k) of the National Housing Act (NHA). The objective of the revision is to enable HUD to promote and facilitate the restoration and preservation of the Nation's existing housing stock.

As in the other single family mortgage insurance programs, a Section 203(k) mortgage is funded by a HUD approved lender and the mortgage is insured by the Department. This Handbook details the procedures to follow to insure a mortgage under Section 203(k). Where a change in processing is not specifically identified, outstanding instructions established for mortgages insured under the Section 203(b) program will apply.

1-2. REGULATIONS. The provisions of Section 203(k) are located in Chapter II of Title 24 of the Code of Federal Regulations under Section 203.50 and Sections 203.440 through 203.495.

1.3. 203(k) - HOW IT IS DIFFERENT. Most mortgage financing plans provide only permanent financing. That is, the lender will not usually close the loan and release the mortgage proceeds unless the condition and value of the property provide adequate loan security. When rehabilitation is involved, this means that a lender typically requires the improvements to be finished before a long-term mortgage is made.

When a homebuyer wants to purchase a house in need of repair or modernization, the homebuyer usually has to obtain financing first to purchase the dwelling; additional financing to do the rehabilitation construction; and a permanent mortgage when the work is completed to pay off the interim loans with a permanent mortgage. Often the interim financing (the acquisition and construction loans) involves relatively high interest rates and relatively short amortization periods. The Section 203(k) program was designed to address this situation. The borrower can get just one mortgage loan, at a long-term fixed (or adjustable) rate, to finance both the acquisition and the rehabilitation of the property. To provide funds for the rehabilitation, the mortgage amount is based on the projected value of the property with the work completed, taking into account the cost of the work.

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To minimize the risk to the mortgage lender, the mortgage loan (the maximum allowable amount) is eligible for endorsement by HUD as soon as the mortgage proceeds are disbursed and a rehabilitation escrow account is established. At this point the lender has a fully insured mortgage loan.
1-4. ELIGIBLE PROPERTY. To be eligible, the property must be a one- to four-family dwelling that has been completed for at least one year. The number of units on the site must be acceptable according to the provisions of local zoning requirements. All newly constructed units must be attached to the existing dwelling. Condominium and Cooperative units are not eligible.

Homes that have never been completed cannot be accepted into the 203(k) program; construction of the property must have been completed for at least one year. Evidence of completion would be a Certificate of Occupancy or other similar documentation from the local jurisdiction.

Homes that have been demolished, or will be razed as part of the rehabilitation work, are eligible provided the existing foundation system is not affected and will still be used. The complete foundation system must remain in place. A report from a licensed structural engineer is required stating that the existing foundation is structurally sound and capable of supporting the proposed construction of the dwelling. Where the home has been completely razed (or where only the footings remain), including the demolition of the foundation, the property is not eligible for a 203(k) insured loan, but could be acceptable as new construction under Section 203(b).

In addition to typical home rehabilitation projects, this program can be used to convert a one family dwelling to a two, three, or four-family dwelling. An existing multi-unit dwelling could be decreased to a one- to four-family unit.

An existing house on another site can be moved onto the mortgaged property; 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.

A manufactured (mobile) home that was built after June 15, 1976, and has been on a permanent foundation for over one year, can be rehabbed with this program. The unit must have been delivered to the site when it was new, prior to being occupied. The rehabilitation cannot affect the structural components of the home that were designed and constructed in conformance with the Federal Manufacturers Construction and Safety Standards. Refer to HUD Handbook 4145.1 REV-2 for additional information, especially for the licensed engineer's certification.

1-5. HOW THE PROGRAM CAN BE USED. This program can be used to accomplish rehabilitation and/or improvement of an existing
one-to-four unit dwelling in one of four ways:

A. To purchase a dwelling and the land on which the dwelling is located and rehabilitate it.

B. To purchase a dwelling on another site, move it onto a new foundation on the mortgaged property and rehabilitate it.

C. To refinance existing indebtedness and rehabilitate such a dwelling.

D. To rehabilitate such a dwelling.

1-6. MORTGAGE POSITION. Mortgages that do not involve the insurance of advances, the refinancing of outstanding indebtedness or the purchase of the property need not be a first lien on the property, but will not be junior to any lien other than a first mortgage.

For A and C in paragraph 1-5., the mortgage must be a first lien on the property and the loan proceeds (other than rehabilitation funds) may be available before the rehabilitation begins.

For B in paragraph 1-5., the mortgage must be a first lien on the property; however, loan proceeds cannot be made available until the unit is attached to the new foundation (see paragraph 1-4.).

For D in paragraph 1-5., the mortgage may be a second lien on the property; however, no insured advances will be allowed and the mortgage cannot be endorsed until all work is satisfactorily completed (see paragraph 5-1.A.). The minimum mortgage amount must exceed the limits of a loan under Title I of the National Housing Act.

1-7. ELIGIBLE IMPROVEMENTS. Mortgage proceeds must be used in part for rehabilitation and/or improvements to a property. There is a minimum $5000.00 requirement for the eligible improvements on the existing structure on the property. Minor or cosmetic repairs by themselves are impracticable and unacceptable; however, they may be added to the minimum requirement (in addition to $5,000). The mortgage must include one or more of the items listed below, with a cumulative minimum of $5,000.

A. Structural alterations and reconstruction (e.g., additions to the structure, finished attics, repair of termite damage and the treatment against termite infestation, etc.)

B. Changes for improved functions and modernization (e.g., remodeled kitchens and bathrooms).

C. Elimination of health and safety hazards (including the resolution of defective paint surfaces and/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).

F. Reconditioning or replacement of plumbing (including connecting to public water and/or sewer system), heating, air conditioning and electrical systems.

F. Roofing, gutters and downspouts.

G. Flooring, tiling and carpeting.

H. Energy conservation improvements (e.g., new double pane windows, insulation, solar domestic hot water systems, etc.).

I. Major landscape work and site improvement, patios 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.

J. Improvements for accessibility to the Handicapped.

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When basic improvements are involved, the following costs can be included in addition to the minimum $5,000 requirement for the existing structure:

- Construction or rehabilitation of a detached garage or an attached unit(s) to the existing dwelling (if allowed by the local zoning ordinances).

- New cooking ranges, refrigerators and other appurtenances (Used appliances are not eligible).

- Interior or exterior painting.

Luxury items and improvements that do not become a permanent part of the real property are not eligible as a cost rehabilitation. The items listed below (not limited to this list) are not acceptable under the 203(k) program, including the repair of any of the following:

Barbecue pits; bathhouses; dumbwaiters; exterior hot tubs, saunas, spas and whirlpool baths; outdoor fireplaces or hearths; photo murals; swimming pools; television antennas and satellite dishes; tennis courts; tree surgery. Additions or alterations to provide for commercial use are not eligible.

1-8. REQUIRED IMPROVEMENTS. All rehabilitation construction and/or additions financed with Section 203(k) mortgage proceeds must comply with the following:
A. Cost Effective Energy Conservation Standards.

1) Addition to Existing Structure. New construction must conform with local codes and HUD Minimum Property Standards in 24 CFR 200.926d (HUD Handbook 4910.1, Appendix K) is required.

2) Rehabilitation of Existing Structure. To improve the thermal efficiency of the dwelling, the following are required:
   a) Weatherstrip all doors and windows to reduce infiltration of air when existing weatherstripping is inadequate or nonexistent.
   b) Caulk or seal all openings, cracks or joints in the building envelope to reduce air infiltration.
   c) Insulate all openings in exterior walls where the cavity has been exposed as a result of the rehabilitation. Insulate ceiling areas where necessary.
   d) Adequately ventilate attic and crawl space areas.

For additional requirements, refer to 24 CFR Part 39, Appendix A-1 through A-6 for standards that apply to improvements proposed as part of the rehabilitation.

3) Replacement Systems.
   a) Heating, ventilating, and air conditioning system supply and return pipes and ducts must be insulated whenever they run through unconditioned spaces.
   b) Heating systems, burners, and air conditioning systems must be carefully sized to be no greater than 15 percent oversized, except to satisfy the manufacturers’ next closest nominal size.

If a new heating/cooling system is proposed, provide heat loss/heat gain calculations for the entire house to ensure proper sizing of heating system. Use the design criteria developed by the American Society of Heating, Refrigerating and Air Conditioning Engineers (ASHRAE) or Manual J developed by the National Environmental Systems Contractors Association.
B. Smoke detectors. Each sleeping area must be provided with a minimum of one (1) approved, listed and labeled smoke detector installed adjacent to the sleeping area. The detector must sense visible or invisible particles of combustion. When activated, the detector must provide an alarm suitable to warn occupants within the sleeping area.

Smoke detectors may be battery powered when installed in existing or rehabilitated dwellings. However, where new construction is being added to an existing building, the smoke detector must receive its primary power from the building wiring, in conformance to local codes and ordinances.

1-9. DEFINITIONS FOR USE IN THE 203(k) PROGRAM.

A. Insurance of advances. This refers to insurance of the mortgage prior to the rehabilitation period.

A mortgage that is a first lien on the property is eligible to be endorsed for insurance following mortgage loan closing, disbursement of the mortgage proceeds, and establishment of the Rehabilitation Escrow Account.

The mortgage amount may include funds for the purchase of the property or the refinancing of existing indebtedness, the costs incidental to closing the transaction, and the completion of the proposed rehabilitation. The mortgage proceeds allocated for the rehabilitation will be escrowed at closing in a Rehabilitation Escrow Account.

B. Rehabilitation Escrow Account. When the loan is closed and Insurance of Advances is used, the proceeds designated for the rehabilitation or improvement, including the contingency reserve, mortgage payment reserve and monies retained under the Escrow Commitment Procedure, are to be placed in an interest bearing escrow account insured by the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA). This account is not an escrow for the paying of real estate taxes, insurance premiums, delinquent notes, ground rents or assessments, and is not to be treated as such.

1) The lender (or its agent) will release escrowed funds upon completion of the proposed rehabilitation in accordance with
the Work Write-up (see example of a Rehabilitation Checklist in Appendix 1) and the Draw Request (Form HUD 9746-A in Appendix 9). Release of funds for completed work cannot occur until one day following loan closing (see paragraph 4-9).

2) The net income earned by the Rehabilitation Escrow Account must be paid to the mortgagor. The method of such payment is subject to agreement between mortgagor and mortgagee. However, payment of the interest income on the Rehabilitation Escrow Account can accumulate and be paid in one lump sum after completion of rehabilitation and issuance of the Final Release Notice. When the Escrow Commitment Procedure is used, interest on the investor's escrow account can be paid when the loan is assumed. Provide an Applicant's Acknowledgement shown in Appendix 4.

3) During rehabilitation the lender may not release funds from the Rehabilitation Escrow Account until the lender has received a Compliance Inspection Report (Form HUD 92051) and the Draw Request (Form HUD 9746-A), certifying that the work has been completed in compliance with the accepted architectural exhibits.

The final release of the escrowed rehabilitation funds is to take place only after the local jurisdiction has provided its final acceptance of the work and the HUD or the Direct Endorsement (DE) Underwriter has reviewed the final Compliance Inspection Report and the Draw Request form.

The Final Release Notice (Appendix 7, as applicable) can be issued, authorizing the final payment, which may include the interest earned on the escrow account and the total of all holdbacks (see paragraph 1-9.B. and E.). This Notice also directs the prepayment of the mortgage by the amount remaining in the contingency reserve and any unused inspection fees or mortgage payments, when applicable.

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C. Rehabilitation Loan Agreement. When the mortgage involves the insurance of advances, a Rehabilitation Loan Agreement must be executed by the lender and the borrower (see Appendix 2). The Rehabilitation Loan Agreement establishes the conditions under which the lender (or its agent) will release funds from the Rehabilitation Escrow Account to aid the borrower in the rehabilitation or improvement of the property. When the lender uses the services of an agent, the lender remains responsible for the actions of that agent. See paragraph 5-2.C. for information on how to release funds.

D. Inspections. All inspections are performed by HUD-approved fee
inspectors assigned by the HUD Field Office (but paid by the lender) or on the HUD-accepted staff of the DE lender (see paragraph 5-2.C.). The fee inspector is to use the architectural exhibits in order to make a determination of compliance or non-compliance. The HUD accepted Plan Reviewer can be allowed to do the fee inspections on the property, because he/she is already familiar with the proposed improvements and can inspect the rehabilitation knowing what was accepted in the work write-up (see paragraph 3-2.F.).

When the inspection is scheduled due to a request for payment, the inspector is to indicate on the Compliance Inspection Report (Form HUD 92051) whether or not the work has been completed. Also, the inspector must use the Draw Request form (Form HUD 9746-A, Appendix 9). The first draw must not be scheduled until the lender has determined that the applicable building permits have been issued.

The inspection fees are paid by the mortgagor, but, the lender is responsible to ensure that payment is made to the inspector (see paragraph 1-13.D.). If the inspection fee is part of the escrow, then it can be released along with the release of the escrow funds as a result of an acceptable Draw Request.

E. Holdback. A ten (10) percent holdback is required on each release from the Rehabilitation Escrow Account. The total of all holdbacks may be released only after a final inspection of the rehabilitation and issuance of the Final Release Notice. The lender (or its agent) may retain the holdback for a maximum of 35 calendar days unless State law allows for a longer time period to ensure that no liens are placed on the property. At lenders option, the holdback is not required when a subcontractor is 100% complete with a work item, the work completed is acceptable to the inspector and the subcontractor provides the necessary lien waivers. Also refer to paragraph 5-2.E.

F. Contingency Reserve. At the discretion of the Field Office or the DE Underwriter, the cost estimate may include a contingency reserve if the existing construction is less than 30 years old or the nature of the work is complex or extensive. A contingency reserve is required when there is evidence of termite damage or previous termite infestation.

For properties older than 30 years the cost estimate must include a contingency reserve of 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 the utilities were not turned on for inspection, a minimum fifteen (15) percent is required. If the scope of work is well defined and uncomplicated, and the
rehabilitation cost is less than $7,500, the lender may waive the requirement for a contingency reserve. A notice about the Contingency Reserve must be provided to the borrower prior to, or at, the closing of the loan (see Appendix 4).

The reserve cannot be used to make additional improvements to the dwelling that are considered luxury items; however, it may be used to pay for added construction costs caused by deficiencies (health, safety and necessity) discovered during rehabilitation. Use a Request for Change, Form HUD 92577, when the scope of rehabilitation will be affected. When adjustments to the proposed rehabilitation (i.e., deleting a skylight from the work writeup) are made following loan closing, the amount by which the costs are reduced are added to the contingency reserve. Any unused portion of the Contingency Reserve Fund remaining at the time of issuance of the Final Release Notice must be applied to reduce the mortgage balance. Work items cannot be deleted from the rehabilitation if it will decrease the value of the home, since the loan has already closed.

If the Borrower feels that the contingency reserve will not be used and they wish to avoid having the reserve applied to reduce the mortgage balance after issuance of the Final Release Notice, the borrower (or any other person, organization or agency on the borrower's behalf) may place their own funds into the contingency reserve account. In this case, if monies are remaining in the account after the Final Release Notice is issued, the monies may be released back to the borrower (or other person, organization or agency who placed the money in the contingency reserve).

If the mortgage is at the maximum mortgage limit for the area or for the particular type of transaction, but a contingency reserve is required, the contingency reserve must be placed into an escrow account from other funds of the borrower at closing. Under these circumstances, if the contingency reserve is not used, the remaining funds in the escrow account will be released to the borrower after the Final Release Notice has been issued.

G. Mortgage Payment Reserve. Funds not to exceed the amount of six (6) mortgage payments (including PITI and the mortgage insurance premium) can be included in the cost of rehabilitation and deposited in the rehabilitation escrow account to assist a mortgagor (whether a principal residence or an investment property) when the property is not occupied during rehabilitation.

On multi-unit properties, if one or more units is occupied, the mortgage payment must be reduced accordingly. If the owner occupies one of the units, or if the rents received are not
sufficient to cover that portion of the mortgage, then the mortgage payment will be reduced by dividing the PITI by the number of units in the property (i.e., the monthly mortgage payment for a triplex is $1,248; if one unit is occupied, the mortgage payment is reduced to $832).

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The number of mortgage payments cannot exceed the completion time frame required in the Rehabilitation Loan Agreement. The lender must make the monthly mortgage payments directly from the interest bearing reserve account. Monies remaining in the reserve account after the Final Release Notice is issued, or occupancy of the property, must be used to reduce the mortgage principal.

1-10. MAXIMUM MORTGAGE AMOUNT. The mortgage amount, when added to any other existing indebtedness against the property, cannot exceed the applicable loan-to-value ratio and maximum dollar amount limitations described in 24 CFR 203.50. The downpayment requirements are the same as under the Section 203(b) program (refer to HUD Handbook 4155.1, paragraph 2-4 for additional information. Also refer to paragraph 6-1 for requirements for incentives to sell HUD-owned properties). The Mortgage Payment Reserve is considered a part of the cost of rehabilitation for determining the maximum mortgage amount (see paragraph 1-9.G.).

A. Maximum Mortgage Calculation. Based on the lesser of:

1) The estimate of As-is value or the purchase price of the property before rehabilitation, whichever is less, plus the estimated cost of rehabilitation and allowable closing costs; or

2) 110 percent of the expected market value of the property upon completion of the work plus allowable closing costs.

Principal Residence (Owner-occupant)

The maximum mortgage amount is based on 97/95 percent of 1) or 2) above.

Investment Property (Non-Occupant Mortgagor or Builder/Rehabber)

The maximum mortgage amount is based on 85 percent of 1) or 2) above.
Escrow Commitment Procedure (Builder/Rehabber)

See Appendix 10 for an example for calculating the maximum mortgage amount using the escrow commitment procedure. This procedure cannot be used for a loan amount less than the 97/95% calculated for an owner-occupant (the loan can be assumed by an investor, however, the mortgage principal must be paid down to what the mortgage would be to an investor).

A mortgagor (Builder/Rehabber/Investor, not an owner/occupant) that purchases or refinances an investment property but intends to sell the rehabilitated property to a mortgagor acceptable to HUD (who intends to occupy the property as a principal residence) can obtain a mortgage based on the loan-to-value ratio and maximum dollar amount limitations prescribed under Section 203(b) for a principal residence, provided:

-- The dollar difference between the maximum mortgage amount (97/95 of the fair market value for an owner-occupant) and the mortgage amount available to an investor (85% of acquisition cost) will remain in escrow with the lender until the property is assumed by an owner-occupant acceptable to the Commissioner;

and

-- The escrowed funds will be administered under the Escrow Commitment Procedure;

Use Form FHA-314, Escrow Commitment Certificate, for this procedure. The commitment may be issued for the maximum mortgage amount for the longest term permissible, 30 years. Refer to paragraph 4-5 for information concerning financial requirements for an investor who uses this procedure.

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To allow for maximum owner-occupant financing when the loan is assumed (by an owner-occupant acceptable to HUD) and to avoid the extra cost for a new mortgage, the mortgage may be based on the market value of the property after rehabilitation. The difference between the maximum mortgage requirements for an owner-occupant and an investor would be retained in an escrow account.

The investor/builder must sign a Statement of Understanding similar to that shown in Appendix 8 and must provide the lender an acceptable plan on how the property will be marketed for assumption by an
acceptable owner-occupant purchaser.

The investor/builder may elect to use the escrow funds to reduce the principal balance at any time prior to the 18th month. If the property is not sold prior the 18th amortization payment of the mortgage, the entire escrow amount must be applied to reduce the principal balance and reduce the mortgage amount to an amount available as an investment property.

The owner-occupant who assumes the loan must provide a downpayment based on 97/95% (unless they qualify under the first time homebuyer provision below). If the resale price is less than the appraised value of the property, the mortgage amount must be reduced accordingly based on the acquisition price. If the resale price is greater than the appraised value, the purchaser must make a larger downpayment. Refer to the example in Appendix 10. For mortgage calculations for refinance transactions, see paragraph 4-7.

If the purchaser is a "first time homebuyer," the assumption can be done with no downpayment requirement. A "first time homebuyer" is defined as a person(s) who has not had an ownership interest in a principal residence within the three years preceding the date of the execution of the mortgage loan documents. Each borrower must certify to the above ownership interest. To verify this requirement, the lender must obtain certified copies of signed federal income tax returns filed by the eligible borrower for the three tax years immediately preceding execution of the mortgage loan documents. If the borrower was not required by law to file a federal income tax return for any of these three years and did not so file and certifies to such, then the requirement is waived.

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the mortgagor will pay on that portion of the mortgage proceeds allocated to the rehabilitation.

C. Waiver of the Market Value Limitation. The 203(k) Regulations allow for a waiver of the market value limitation stated in paragraph 1-10.A. to facilitate use of the program. Such requests must be forwarded to the Assistant Secretary for Housing-Federal Housing Commissioner at the HUD Headquarters. Requests must include documentation that the three following conditions are present:

1) The property is located within an area which is subject to a community sponsored program of concentrated redevelopment or revitalization (see 24 CFR Part 220). Use the same criteria as in paragraph 4-6 to determine if the communities plan for redevelopment or revitalization will be adequate.

2) The market value loan limitation prevents the use of the program to accomplish rehabilitation in the subject area.

3) The interests of the borrower and the Secretary of HUD are adequately protected.

D. Solar Energy Increase in Dollar Limitation. A mortgage is eligible for an increase of up to 20 percent in the maximum insurable mortgage amount, if such an increase is necessary for the installation of solar energy equipment. The solar energy system's contribution to value will be limited by its replacement cost or by its effect on the value of the dwelling.

1-11. INTEREST RATE and DISCOUNT POINTS. These are not regulated and are negotiable between the borrower and the lender.

1-12. AMORTIZATION. Provisions of the Section 203(k) mortgage (prescribed in Section 203.21 of the Regulations) are the same as prescribed under Section 203(b).

1-13. MAXIMUM CHARGES AND FEES. The statutory requirements and administrative policies of Section 203(k) result in deviations from the maximum amount of charges and fees permitted under Section 203(b). The lender is responsible to ensure that the plan reviewer, appraiser and inspector are paid for their services.

A. Supplemental Origination Fee. When the Section 203(k) mortgage involves insurance of advances, the mortgagee may collect from the mortgagor a supplemental origination fee. This supplemental origination fee is calculated as one and one-half percent (1 1/2%) of the portion of the mortgage allocated to rehabilitation, or $350, whichever is greater. This supplemental origination fee is collected in addition to the one percent origination fee on the total mortgage amount.
B. Plan Review Fee. Prior to the appraisal, a HUD accepted plan reviewer (or fee consultant, paid by the lender) must visit the site to ensure compliance with the program requirements in this handbook. The utilities should be on for this site review to take place; if the utilities are off, the contingency reserve will be 25% (see paragraph 1-9.F.). The fee is as follows and may not be changed without HUD Headquarters approval:

1) Initial review prior to appraisal:

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<th>Fee</th>
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<td>&lt; $15,000</td>
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2) Additional unit review (two to four units with same case number) - $ 50.00 per unit

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3) Additional review (reinspection of the same unit) - $50.00

When travel distance exceeds 30 miles round trip from the reviewer's place of business, a mileage charge of 33 cents per mile may be applied to the above charges, including toll road and other charges where applicable.

If the Plan Reviewer is acting as a consultant for the borrower, then the plan review stage can be eliminated and the Plan Review Fee is not applicable. The Plan Reviewer can still do the inspections during the construction stage. The Plan Reviewer cannot be the contractor on the job, because it is considered a conflict-of-interest.

C. Appraisal Fee. Two appraisals must be performed: (1) As-is value of the property; and (2) Estimated market value of the property assuming completion of the rehabilitation. The maximum fee which a lender may collect for these two appraisals is one and one-half times the amount permitted for a Section 203(b) proposed construction appraisal, as established by the HUD Field Office.

D. Inspection Fee (during the rehabilitation construction period). Established by the local HUD Field Office (see paragraph 5-2.C.), however, Field Offices wanting to set a fee greater than $50 must obtain Headquarters approval.

1) Fees for inspections will be allowed for inclusion in the cost of rehabilitation. If all inspections are not required, remaining funds will be applied to the principal after the final release notice is issued.
2) If additional inspections are required by the lender to ensure satisfactory compliance with exhibits, the borrower or contractor will be responsible for payment; however, the lender has ultimate responsibility.

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E. Title Update Fee. To protect the validity of the mortgage position from mechanics liens on the property, reasonable fees charged by a title company may be included as an allowable cost of rehabilitation. Where the mortgage position is protected and is not in jeopardy, this fee may not apply. Borrowers may wish to obtain lien protection, but the fees must be paid by the borrower where such lien protection is not required to ensure the validity of the security instrument (see paragraph 1-20).

The allowable fee should not exceed $50.00 per draw release. If all draw inspections are not made, monies left in escrow must be applied to reduce the mortgage balance.

1-14. APPLICATION FORMS AND REQUIRED DOCUMENTATION. The lender prepares applications for conditional commitment for mortgage insurance on Form HUD-92800, HUD Application for Property Appraisal and Commitment. Form HUD-92900, HUD/FHA Application for Commitment for Insurance under the National Housing Act or other form approved by HUD, is used for the firm commitment application. Other appropriate forms will be used to complete the processing of the application and exhibits as described in this Handbook.

A. Supporting Documentation. The borrower may pay discounts on the rehabilitation and, when applicable, the refinance portion of the mortgage, as well as an additional origination fee when the mortgage involves the insurance of advances. These charges are to be totaled and included as part of the cost of rehabilitation to be posted in line (b) of Section 24 of the Form HUD-92900.

When the Section 203(k) mortgage is to be subordinate to an existing first mortgage, the mortgagee is to submit a complete verification of the first mortgage. Include the name and address of the note holder; the type of mortgage; date of obligation; original mortgage amount; unpaid balance; monthly payment to principal and interest; the maturity date; and whether the amount required for taxes and insurance is impounded.
B. Processing. As with the Department’s other single family programs, the mortgage insurance application procedure consists of three separate steps: application for the conditional commitment; application for the firm commitment; and request for mortgage insurance endorsement. Processing by a DE lender is described in paragraph 1-19.

1-15. MORTGAGE DOCUMENTS. The Rehabilitation Loan Agreement, Security Instrument, Note and other documents used in processing and closing the mortgage must comply with State and local requirements.

A. Rehabilitation Loan Agreement. This agreement between the lender and the borrower establishes the conditions under which the lender will advance the 203(k) mortgage proceeds. The language of the Rehabilitation Loan Agreement is to follow the format presented in Appendix 2.

The Rehabilitation Loan Agreement is incorporated by reference and made a part of the Security Instrument.


1) If the mortgage involves releases from the Rehabilitation Escrow Account, the following language should be typed in the form:

"Provisions pertaining to releases are contained in the Rehabilitation Rider which is attached to this mortgage, and made a part hereof."

A Rehabilitation Rider is contained in Appendix 3 and is a required modification to the Security Instrument.

2) In those cases where the mortgage is a second lien, the following language should be typed in the form:

"Notwithstanding any other provision to the contrary, this Security Instrument is superior to all liens on the property, other than a mortgage dated _____, 19____, and published in book _________ at __________.

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this Handbook; and (2) be taken by a mortgagor who complies with the mortgage credit provisions as prescribed, or referenced in this Handbook.

All insurance funds received and all disbursements made pursuant to a Section 203(k) mortgage are credited or charged to the General Insurance Fund. The Mortgage Insurance Premium is paid monthly.

1-18. CLAIM FOR INSURANCE BENEFITS. Refer to paragraph 5-2.F. A claim for insurance benefits on a loan secured by a first mortgage is to be made, and insurance benefits are paid, in accordance with the provisions of Section 203.350 through Section 203.404 of Title 24 of the Code of Federal Regulations. These sections explain under what conditions a mortgage is to be assigned or conveyed to the Secretary in exchange for payment of insurance benefits. Insurance benefits are paid in cash or debentures, at the Secretary's discretion.

In the event of a mortgagor default on a Section 203(k) mortgage secured by other than a first mortgage, in order to be eligible for insurance benefits the lender must assign the mortgage to the Secretary in the manner prescribed in Sections 203.440 through 203.495 of Title 24 of the Code of Federal Regulations. A 203(k) mortgage endorsed as a second mortgage must, at the time of assignment, be prior to all mechanics and materialmen's liens filed of record, regardless of when such liens attach, and prior to all liens and encumbrances or defects which may arise, with the exception of the first mortgage. The lender may not, except with the approval of the Department, proceed against the security and also make claim against the contract for insurance. Insurance benefits are paid in cash, although HUD regulations provide for payment in debentures if the claimant requests.

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1-19. DIRECT ENDORSEMENT (DE). DE Lenders have the option of (1) processing 203(k) insured loans fully under the DE program, or (2) obtaining a conditional commitment from HUD and processing the borrower under DE, or (3) processing the case totally through HUD's prior approval process.

Although DE lenders will be eligible to process 203(k) under the DE procedure, the underwriters must be trained and submit 203(k) test cases before full approval for DE processing of 203(k) insured loans will be granted. The following conditions apply:

A. All unconditionally approved DE lenders are eligible to process Section 203(k) applications after satisfactorily completing a training session given by the local HUD Field Office. Of particular importance at the training session is a discussion of the proper submission of the architectural exhibits and the Draw Request (Form HUD 9746-A, Appendix 9).

In addition, the HUD Field Office will review several 203(k) cases on a pre-closing basis to ensure conformity with
outstanding instructions. The number of cases reviewed (typically 3 to 5 cases) is dependent on the assessment of quality in underwriting and exhibit preparation. If the lender has not been authorized DE authority under the 203(b) program and wishes to obtain DE authority under 203(k), then the pre-closing review of 15 cases is required. Upon successful completion, the mortgagee may submit the cases for endorsement. HUD field reviews of the construction and a post-endorsement review of the file documentation must be adequate to ensure compliance with outstanding instructions.

B. An eligible DE lender may process a Section 203(k) application for any property located within the jurisdiction of the appropriate HUD Field Office. If a property is in a Section 223(e) area, the DE lender cannot process this type of property and must refer the case the HUD Field Office for processing.

C. Eligible lenders may use their own staff to perform Section 203(k) appraisals, compliance inspections and review of architectural exhibits. However, these individuals must be approved by the HUD Field Office and attend any training session that is required by HUD. Lenders may also use HUD fee panel members which can be assigned by the local HUD Field Office.

D. The DE lender will be fully responsible for processing the Section 203(k) application, including the authority to make releases from the rehabilitation escrow account as the work progresses. The lender's DE Underwriter must sign and date the Compliance Inspection Report (Form HUD 92051) and the Draw Request (Form HUD 9746-A) authorizing release of the monies from the escrow account. Copies of the forms must be sent to the appropriate HUD Field Office (Architectural Branch) after each inspection for recordkeeping and field review purposes.

E. If a problem is noticed, the HUD Field Office may request the Departmental Monitoring Division to review the DE Underwriter's file in the lender's office.

F. The DE lender must provide certifications with each mortgage as required under 24 CFR 200.163 (b), (c) and (f). The DE lender must use Form HUD 54113 to comply with the certification requirements. The certifications are in Mortgagee Letter 90-36, dated September 28, 1990, and will be treated as an Addendum to Appendix 3 and Appendix 4 of HUD Handbook 4000.4 REV-1, until that handbook can be updated to incorporate the 203(k) certifications. Form HUD 54113 must be modified by adding "or applicable Mortgagee Letter" immediately after the phrase "as detailed in the Single Family Direct Endorsement Program Handbook" which appears in both the underwriter certification and the mortgagee certification.
LENDER'S QUALITY CONTROL PLAN. It is extremely important to properly monitor the receipt and disbursement of the rehabilitation funds, including the interest earned on the escrow account. Lender's originating a Section 203(k) mortgage and the investing mortgagee buying these mortgages must provide a Quality Control Plan to the local HUD Field Office that describes the method(s) they will use to account for the release of Rehabilitation Escrow funds. Each lender's quality control plan must also describe the method the lender uses to comply with 24 CFR 203.4(b)(3).

The originating lender, its sponsor or the investing mortgagee must maintain an accounting system acceptable to HUD that properly records all transactions from the escrow account. If the originating lender's sponsor or investor is recording the transactions, it must distribute copies of the record of transactions to the originating mortgagee, the borrower and to HUD on each Draw Request (refer to Appendix 13 for a suggested format).

Unless otherwise agreed to by the mortgagee's sponsor and/or the investing mortgagee, the originating mortgagee is responsible to ensure timely coordinated draw requests, change orders, contingency requests, lien endorsements as necessary, and escrow account releases with the borrower, contractor, inspector, HUD (or DE Underwriter) and the investing mortgagee, and to maintain recordkeeping reflecting such requests and disbursements.

The investing mortgagee is ultimately responsible for the proper and timely "good funds" distribution from the escrow account and the validity of the mortgage position. However, HUD looks to the originating lender, its sponsor and the investing mortgagee to ensure the proper distribution of all funds. The Department encourages lenders to use independent title companies to ensure the proper distribution of the escrow account funds at loan settlement and to protect the validity of the security instrument position against liens.

"Identity-of-interest" closing agents are not allowed under the 203(k) program. An identity-of-interest exists if the originating lender, mortgagee of record, or mortgagor (or any general or limited partner, shareholder, director, officer, employee or authorized representative of the lender) can directly, or through one or more intermediaries, control or influence the decisions or policies of the closing agent or its employees, or vice versa. An identity-of-interest exists whenever there is a financial, family relationship, professional or business affiliation involved.

HUD encourages investing (secondary) mortgagees to have Errors and
Omissions coverage and Fidelity coverage. The investing mortgagee should require it for the originating lender when the originating lender is administering the rehabilitation escrow account to ensure compliance with the mortgagee's responsibilities to their mortgagors.

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