

Legal Opinion: CIS-0089

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Subject: Homes Purchased That Were Found to Need Serious Repair
- FHA Legal Responsibilities

August 8, 1996

Ms. Doreen Dunn
10325 Yale Avenue
Cleveland, OH 44108

Dear Ms. Dunn:

This is in response to your letter dated July 8, 1996, addressed to "OGC" at the address for this Department. "OGC" is the Office of General Counsel, which provides legal advice and assistance to the program offices that actually administer the programs of the Department. Because you addressed your letter to "OGC" I am assuming that you are specifically interested in the legal aspects of the matter that you raised, and this response will proceed accordingly.

Your letter concerns the experiences of yourself and others regarding homes that were purchased with a mortgage insured by the FHA, part of the Department, and later found to be in need of serious repair. There are two aspects of your question: the responsibilities of the lender and the responsibilities of the borrower/purchaser. Regarding responsibilities of the lender, ordinarily the Department does not require a separate inspection by the lender when the home involves existing construction that has been completed for at least a year. The lender must obtain an appraisal of the home by a State-licensed or State-certified appraiser who is required to assess the property condition as part of the process of valuing the home. The appraiser notes any repairs needed for the home to meet the minimum FHA building standards for existing homes, and arrives at a value of the home that assumes that the required repairs are completed before the mortgage loan is made. The lender is responsible for ensuring that the repairs are made. While the borrower/purchaser benefits when the required repairs are made, the purpose of the appraisal and repair requirements is not to directly benefit the borrower/purchaser but to assure FHA that the mortgage insured by FHA will be on a home that is sound in case FHA or the lender should need to acquire the home as a result of a mortgage default.

The formal legal statement of the Department's position appears in the Code of Federal Regulations at 24 CFR 200.145. Section 200.145 states:

(a) The mortgagor is responsible for making those investigations, analyses and inspections it deems necessary for protecting its interests in the property.

(b) Any appraisals, inspections, environmental assessments, and technical or financial evaluations conducted by or for the Commissioner are performed to determine the maximum insurable mortgage and to protect the Commissioner and the FHA insurance funds. Such appraisals, inspections, assessments and evaluations neither create nor imply a duty or obligation from HUD to the mortgagor, or to any other party, and are not to be regarded as a warranty by HUD to the mortgagor, or any other party, of the value or condition of the property.

As most recently revised on April 1, 1996.

This rule was adopted by the Department to codify the results of various lawsuits in which the Department successfully defended itself against liability for allegedly defective inspections under the FHA programs; e.g., *United States v. Neustadt*, 366 U.S. 691 (1961).

The Department realizes that most borrowers/purchasers are not familiar with the contents of the Code of Federal Regulations and might, without further guidance, reasonably assume that the involvement of the Federal Government with a mortgage (although FHA involvement with a particular loan occurs after the lender has actually processed and closed the loan) implies a degree of Federal protection for the borrower. For this reason, current FHA procedures require lenders to provide to each borrower applying for an FHA-insured mortgage the enclosed "Important Notice to Homebuyers" which contains the following paragraph:

Condition of Property

The property you are buying is not HUD/FHA approved and HUD/FHA does not warrant the condition or the value of the property. An appraisal will be performed to estimate the value of the property, but the appraisal does not guarantee the house is free of defects. You should inspect the property yourself very carefully or hire a professional inspection service to inspect the property for you. If you have a professional home service perform an inspection of the property, you may include some of the cost of the inspection in your mortgage.

Each borrower is required to sign a copy of this Notice immediately under the following statement:

Acknowledgement: I acknowledge that I have read and received a copy of this notice at the time of loan application.

(Source of current version of notice: Mortgagee Letter 95-31, July 6, 1995.) The Department has attempted, through these current procedures, to ensure that applicants for FHA-insured mortgages are not misled or misinformed regarding the borrower's responsibilities to determine the property condition. The

Department has no responsibility or ability to rectify the condition of defective properties.

Your letter also suggests that the problems that you cite can be attributed to the fact that the Department relies on lenders to determine property condition for purposes of mortgage insurance instead of having FHA inspectors involved. Prior to 1983 FHA performed all of the steps involved in processing an FHA-insured mortgage that would be made by a private lender, including performing or arranging for all appraisals and any necessary inspections. In 1983 the Department began to phase in "Direct Endorsement" (DE) processing in which the lender performs all processing through loan closing and certifies to the Department compliance with FHA requirements. This form of processing is now used for virtually all FHA-insured single family mortgages. It has enabled the Department to expand significantly the number of mortgages that it insures each year with significant reduction in staff and without loss of overall underwriting quality. FHA employees are increasingly used for monitoring the activities of lenders in lieu of processing individual loans. Given the current budget constraints, it would not be feasible for FHA to return to the days in which FHA employees were directly involved in loan processing. Mortgagees are capable of determining property conditions for FHA mortgage insurance purposes. Because you have raised concerns over the capability of certain lenders to make such a determination, we have referred your inquiry to the Office of Lender Activities which handles mortgagee compliance issues. That Office will see if further review is warranted.

I hope that this letter helps you to understand the Department's legal position.

Sincerely,

Nelson A. Diaz
General Counsel

Enclosures