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Fact Sheet

FHA's 203(k) Loan Program

Community Developments Fact Sheets are designed to share information about programs and initiatives of bankers and community development practitioners. These fact sheets differ from OCC bulletins and regulations in that they do not reflect agency policy and should not be considered regulatory or supervisory guidance. Some of the information used in the preparation of this fact sheet was obtained from publicly available sources. These sources are considered reliable and current, as of June 2021, but the use of this information does not constitute an endorsement of its accuracy by the OCC.

This *Community Developments Fact Sheet* explains the Federal Housing Administration's (FHA) 203(k) Home Rehabilitation Mortgage Insurance Program[1] for national banks and federal savings associations (collectively, banks).

How Can Banks Use the 203(k) Loan Program?

The 203(k) program enables a homebuyer to finance the purchase of a home and the cost of its rehabilitation through a single mortgage. The program also allows borrowers to refinance an existing mortgage and use the proceeds to rehabilitate their homes. The 203(k) program can expand homeownership opportunities and assist in the revitalization of neighborhoods.

What Are the Benefits to Banks That Offer FHA 203(k) Loans?

There are several important benefits for banks that offer 203(k) loans. The program can expand a bank's customer base because these loans provide mortgage credit to borrowers who are unable to make a substantial down payment and also need financing to renovate the property. FHA 203(k) loans may only require a 3.5 percent down payment. These loans produce origination and servicing fee income for banks. Moreover, banks can place 203(k) loans in Ginnie Mae securities, providing them with liquidity and secondary market fee income. Because 203(k) loans are fully insured by the FHA at closing, they also produce income while mitigating risk. These loans may also receive positive consideration in a bank's Community Reinvestment Act evaluation and may enhance bank and nonprofit partnerships because nonprofit organizations are eligible to receive 203(k) loans.

The FHA 203(k) program provides mortgage insurance against loan default, and that insurance is backed by the full faith and credit of the federal government. If a borrower defaults and the lender forecloses on a property, the FHA pays the lender the remaining unpaid principal balance of the loan, accrued interest, and certain expenses

[1] The program is authorized under section 203(k) of the National Housing Act, 12 USC 1709(k).

associated with the foreclosure or other actions necessary to acquire the property. The guarantee reduces the credit risk that banks face in originating and holding or servicing FHA 203(k) loans.

How Does the FHA 203(k) Loan Program Work?

Banks originate 203(k) loans, and the FHA insures these privately issued mortgages. There are two types of 203(k) loans:

- **Standard 203(k) loans** are used by borrowers for projects that require substantial structural renovation, such as major roof repairs, added rooms, or plumbing replacement. The standard 203(k) loan does not have a specific maximum dollar limit for the repairs.
- **Limited 203(k) loans** are used by borrowers for simple or cosmetic repairs, such as new flooring, minor kitchen remodeling, or gutter repair. The limited 203(k) loan has a maximum repair amount of $35,000. For properties in qualified opportunity zones, the maximum repair amount is $50,000 for the first 15,000 loans secured in qualified opportunity zones each calendar year.[2]

For both types of 203(k) loans, the gross loan amount must not exceed the FHA loan limits.[3] The FHA loan limits vary by geography and range, for a single-family unit, from $356,362 in low-cost areas to $822,375 in high-cost areas as of the date of this publication. The FHA allows for up to a 96.5 percent loan-to-value (LTV) ratio on 203(k) purchase loans. On 203(k) refinances, the maximum LTV is 97.75 percent. The value of the property is determined by either (1) the value of the property before rehabilitation plus the cost of rehabilitation, or (2) 110 percent of the appraised value of the property after rehabilitation, whichever is less.

A borrower who obtains a 203(k) mortgage pays both an upfront mortgage insurance premium and an annual mortgage insurance premium. The mortgage insurance premium calculations are based on the LTV of the loan.[4]

Pricing for 203(k) loans is determined by market conditions and the interest rate is typically 1 percent higher than traditional FHA loans. FHA 203(k) loans can be offered for 15- or 30-year terms, and the interest rate can be variable or fixed.

Example of Standard FHA 203(k) Loan

Sources of Funds	
203(k) loan	$241,250
3.5 percent down payment	8,750
Total sources of funds	250,000
Uses of Funds	
Purchase price	$150,000
Rehabilitation cost	92,500
Estimated fees	7,500
Total uses of funds	$250,000

Eligible Borrowers

Individual borrowers who meet the underwriting qualifications for the FHA's 203(b) Single Family Purchase Money Loan Guarantee Program are eligible for 203(k)

[2] Refer to Mortgagee Letter 2019-18, U.S. Department of Housing and Urban Development (HUD) (November 22, 2019).

[3] Refer to FHA *Single Family Housing Policy Handbook* 4000.1 (also referred to as SF Handbook), section II.A.8.a.ix–xi, HUD (November 18, 2020).

[4] Refer to SF Handbook, Appendix 1.0.

loans. Generally, the FHA 203(b) underwriting criteria regarding the borrower's credit history and down payment assistance are less restrictive than conventional underwriting requirements.[5] Borrowers under the 203(k) program may be required to occupy the homes they finance under the program.[6]

Nonprofit organizations approved by the FHA and certain government agencies are eligible borrowers for 203(k) loans, although certain restrictions apply. Nonprofit organizations can use the program to rehabilitate foreclosed FHA-owned, city-owned, and bank-owned properties. Nonprofit developers and government agencies generally may not finance more than 10 203(k) properties in the process of rehabilitation at any one time.

Eligible Properties

The 203(k) program promotes cost-effective energy conservation and renewable-energy upgrades. Properties must be one- to four-family dwellings that have been completed for at least one year.[7] The 203(k) loan can be used to convert a single-family unit into a two-, three-, or four-family dwelling or to convert a multifamily dwelling into a single-family home, as long as the borrower intends to be an owner-occupant. Demolished homes are eligible as long as their existing foundations remain intact. Mixed-use properties qualify when 51 percent of the gross building area is for residential use.[8]

How Do Lenders Participate in the 203(k) Loan Program?

Banks must obtain FHA approval to offer 203(k) loans.[9] Loans are approved through the FHA's automated underwriting system, TOTAL[10] Mortgage Score, or approved by the FHA's Direct Endorsement underwriters. If default occurs, lenders must file a mortgage insurance claim with the FHA.

Construction Phase

The FHA requires that the expected time to complete rehabilitation of the property not exceed six months of loan closing[11]. Some banks establish shorter construction periods, depending on the amount of work needed. As construction progresses, banks disburse funds to the borrower from a rehabilitation escrow account after completed work is reviewed by an FHA-approved inspector. The FHA allows for up to four intermediate draws from the rehabilitation escrow account during rehabilitation, followed by one final draw.[12] A 10 percent holdback is placed on rehabilitation proceeds, which are released after final inspection of the rehabilitation and issuance of the Final Release Notice by the mortgagor.

Under the standard 203(k) program, a U.S. Department of Housing and Urban Development (HUD)-approved 203(k) fee consultant must develop a construction plan with architectural exhibits, along with an accurate cost assessment. An FHA-approved

[5] Refer to SF Handbook, section I.A.

[6] Refer to SF Handbook, section II.A.1.b.iii.

[7] Refer to 24 CFR 203.50(c).

[8] Refer to SF Handbook section II.A.8.a.iii.

[9] Refer to SF Handbook section I.A.

[10] TOTAL stands for Technology Open to Approved Lenders.

[11] Refer to SF Handbook section I.B.4.c.

[12] Refer to SF Handbook, section II.A.8.a.xviii(C)(1)(d).

appraiser uses the construction plan to estimate the future value of the property after work is completed. While taking into account the FHA loan limits, the lender uses the appraisal, along with the original loan application documents, to determine the maximum insurable mortgage amount. Based on this evaluation, the lender issues a commitment letter to the borrower and prepares for the closing date.

Under the limited 203(k) program, a borrower may develop the work write-up and cost estimate without using an independent consultant or contractor to prepare these items.

Operational Considerations for Administering the Program

There are several operational considerations for banks to offer 203(k) loans. Because the number of 203(k) loans originated is usually small, lenders typically have one or two staff members who specialize in originating, underwriting, and administering these loans. Nevertheless, staffing levels vary based on the bank's business model and whether government lending is central to the bank's overall strategy.

Successfully offering 203(k) loans involves approving and monitoring construction draws. Some banks do this internally through a separate construction draw unit; others outsource this function for a premium, typically 1 percent of the total loan, to other lenders.

The FHA *Single Family Housing Policy Handbook* indicates that lenders should conduct proper borrower screening to ensure the borrower is not a for-profit investor. Further, banks should perform necessary due diligence when entering into third-party relationships to originate 203(k) loans. Failure to conduct due diligence steps could lead to the cancellation of FHA insurance on the mortgage.[13]

Regulatory Capital Requirements

Under the regulatory agencies' current risk-based capital requirements, the portion of loans guaranteed by the federal government through the FHA is risk-weighted at 20 percent.[14]

Ability-to-Repay and Qualified Mortgage Requirements

Regulation Z requires creditors to make a reasonable and good faith determination that the consumer will have a reasonable ability to repay a covered transaction at or before consummation.[15] FHA loans are considered "qualified mortgages" under Regulation Z and have a safe harbor or presumption of compliance with the repayment ability requirement.

Community Reinvestment Act

FHA 203(k) loans may assist banks in receiving positive consideration for Community Reinvestment Act (CRA) evaluation purposes. Under the OCC's 2020 CRA rules, which took effect October 1, 2020, an FHA 203(k) loan may be a CRA qualifying activity if the criteria under 12 CFR 25.04 are met. Such criteria include home mortgage loans provided to a low- or moderate-income individual or family, or

[13] Refer to 24 CFR 203.363.

[14] 12 CFR 3.32(a)(1)(ii).

[15] Refer to 12 CFR 1026.43(c).

located in Indian country or other tribal and native lands.[16]

For More Information

OCC Resources

- Community Developments Insights: FHA 203(k) Mortgage Insurance Program: Helping Banks and Borrowers Revitalize Homes and Neighborhoods
- District Community Affairs Officers contact information

Other Resources

- 203(k) Loan Program Overview
- HUD 203(k) Maximum Mortgage Amount Calculator
- FHA *Single Family Housing Policy Handbook* 4000.1 (SF Handbook)
- FHA Loan Limits

[16] Refer to Community Reinvestment Act Regulations, Final Rule, 85 Fed. Reg. 34734 (June 5, 2020). Also refer to the CRA Illustrative List of Qualifying Activities. The list identifies as a CRA-eligible activity a home mortgage loan that is made to a low- or moderate-income individual and that is guaranteed by the FHA.