

**DEPARTMENT OF HOUSING AND
URBAN DEVELOPMENT**

24 CFR Part 203

[Docket No. FR-4701-P-01]

RIN 2502-AH73

**Amendments to the Section 203(k)
Rehabilitation Loan Insurance Program**

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Proposed rule.

SUMMARY: This proposed rule would amend HUD's regulations for the Section 203(k) Rehabilitation Loan Insurance Program (203(k) Program). The 203(k) Program is the Federal Housing Administration's (FHA's) primary program for the rehabilitation and repair of single family properties. First, the proposed rule would limit 203(k) rehabilitation loan insurance to one-unit structures. The proposed rule would also establish a cap on the total cost of rehabilitation. The dollar amount of the rehabilitation could not exceed 20 percent of the FHA statutory single family mortgage limit for a one-unit structure in a "high cost area." These changes would simplify the 203(k) Program for both lenders and homebuyers, and strengthen HUD's capacity to safeguard the FHA Insurance Fund.

DATES: *Comments Due Date:* October 21, 2002.

ADDRESSES: Interested persons are invited to submit comments regarding this proposed rule to the Regulations Division, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-0500. Communications should refer to the above docket number and title. Facsimile (FAX) comments are not acceptable. A copy of each communication submitted will be available for public inspection and copying between 7:30 a.m. and 5:30 p.m. weekdays at the above address.

FOR FURTHER INFORMATION CONTACT: Vance T. Morris, Director, Office of Single Family Program Development, Room 9266, U.S. Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-8000; telephone (202) 708-2121 (this is not a toll-free number). Hearing- or speech-impaired individuals may access this number via TTY by calling the toll-free Federal Information Relay Service at (800) 877-8339.

SUPPLEMENTARY INFORMATION:

**I. Background—The Section 203(k)
Rehabilitation Loan Insurance Program**

Section 203(k) of the National Housing Act (12 U.S.C. 1709(k)) authorizes HUD to insure loans for the purchase and/or rehabilitation and repair of residential properties. The 203(k) Program is HUD's primary program for the rehabilitation and repair of single family properties. Section 203(k) loan insurance enables homebuyers and homeowners to finance both the purchase (or refinance) of a house and the cost of its rehabilitation through a single mortgage. The regulations implementing the 203(k) Program are located in 24 CFR 203.50 and 24 CFR 203.440 through 203.495. HUD's Office of Housing—Federal Housing Administration (FHA) administers the Program.

The 203(k) Program fills a unique and important role for homebuyers. In the conventional loan market, a homebuyer who purchases a home that is in need of repair or modernization usually has to follow a time-consuming and costly process. The homebuyer must obtain financing to purchase the dwelling, additional financing for the rehabilitation work, and a permanent mortgage after rehabilitation is completed to pay off the interim loans. The interim acquisition and improvement loans often have relatively high interest rates and short repayment terms. The 203(k) Program was designed to address this situation. Under this program, a homebuyer may obtain a single loan, at a long-term fixed (or variable) rate, to finance both the acquisition and rehabilitation of the property.

The extent of the rehabilitation covered by 203(k) loan insurance may range from relatively minor (though a minimum of \$5,000 in cost is required) to virtual reconstruction. For example, a home that has been demolished, or will be razed as part of rehabilitation, is eligible provided that some of the existing foundation system remains in place. Section 203(k) loan insurance can also finance the rehabilitation of the residential portion of a property that has non-residential uses.

II. This Proposed Rule

This proposed rule would make two amendments to HUD's regulations for the 203(k) Program. Specifically, the proposed rule would: (1) Limit 203(k) rehabilitation loan insurance to one-unit structures; and (2) establish a cap on the total cost of the rehabilitation. These changes would simplify the program for both lenders and homebuyers, and

strengthen HUD's capacity to safeguard the FHA Insurance Fund. This section of the preamble describes the proposed changes to the 203(k) Program.

A. Limit to One-Unit Structures

Under HUD's regulations at § 203.50(a), the 203(k) Program may be used for the rehabilitation of a one- to four-unit structure that will be used primarily for residential purposes. In addition to typical home rehabilitation projects, this program can be used to convert a one-unit structure to a two-, three-, or four-unit structure. An existing multi-unit structure can be decreased to a one- to four-unit structure. However, the regulations also require that rehabilitation loan transactions must constitute an acceptable risk, as determined by the Secretary of HUD (see § 203.50(e)).

FHA statistics show that over the past eleven years, the 203(k) Program has experienced unacceptably high default rates for multi-unit (*i.e.*, two- to four-unit) properties. The average default rate for 203(k) multi-unit properties is greater than the average default rate for multi-unit properties associated with the Section 203(b) Program (HUD's principal single family mortgage insurance program). For example, during Fiscal Years 1999 through 2001, the average default rate for two-, three-, and four-unit 203(k) properties was 32.8% greater than the average default rate for two-, three-, and four-unit properties under the 203(b) Program. To address these excessive default and claim rates, the proposed rule would amend § 203.50(e) to provide that the Secretary has determined that loan transactions for the rehabilitation of two-, three-, and four-unit structures (other than those involving the conversion of such structures to one-unit structures) constitute an unacceptable risk. This amendment would limit 203(k) loan insurance to one-unit structures. The proposed change would also prohibit the conversion of one-unit structures to two-, three-, or four-unit structures, as well as the expansion of existing two- to four-unit structures to sizes larger than a one-unit structure.

B. Cap on Total Cost of Rehabilitation

Another possible reason for the excessive claim and default rates is that the program is complex for both lenders and homebuyers, especially first time homebuyers. Since the 203(k) Program is used for rehabilitation of a property, financing under the program involves the use of contractors, consultants, engineers, and paperwork not required under other FHA insurance programs.

Simplification of the 203(k) Program will assist in reducing the number of insurance claims and comply with Congressional mandates to maintain the FHA Insurance Fund in a sound actuarial manner.

One method for reducing the complexity of the 203(k) Program is to limit the dollar amount of the rehabilitation. Currently, there is no such restriction, although the cost of the rehabilitation must be \$5,000 or greater and the overall loan amount may not exceed the limits prescribed in § 203.50(f). This proposed rule would provide that the total cost of the rehabilitation may not exceed 20 percent of the FHA statutory single family mortgage limit for a one-unit structure in a "high cost area," irrespective of location. The FHA mortgage limits are established by HUD pursuant to section 203(b)(2)(A) of the National Housing Act (12 U.S.C. 1709(b)(2)(A)). HUD announces these mortgage limits annually through a Mortgagee Letter, typically in late December for effect on January 1st of the following year. The most recent single family mortgage limits are set forth in Mortgagee Letter 01-31, issued on December 28, 2001. A copy of the Mortgagee Letter may be obtained through the HUD Web site at <http://www.hud.gov>. Under Mortgagee Letter 01-31, the maximum mortgage amount for a one-unit structure in a "high cost area" is \$261,609. The total cost of 203(k) rehabilitation would be capped at 20 percent of this amount, or \$52,321. A sampling of data available to FHA indicates that the average dollar amount of rehabilitation on a 203(k) loan in Fiscal Years 1999 and 2000 was approximately \$29,000. Accordingly, HUD believes that the proposed dollar cap on rehabilitation is appropriate to prevent the 203(k) Program from being used for overly complicated and expensive work, while continuing to serve homebuyers purchasing a one-unit structure in need of moderate rehabilitation.

The proposed cap would only include costs related to the actual rehabilitation of the property and would not include costs such as consultant fees, supplemental origination fees, the costs of preparing architectural exhibits, and contingency fees. Additionally, the cap would also exclude: (1) Rehabilitation costs incurred to improve the energy efficiency standards of the home; and (2) six months of mortgage payments.

III. Findings and Certifications

Regulatory Planning and Review

The Office of Management and Budget (OMB) reviewed this rule under Executive Order 12866, *Regulatory Planning and Review*. OMB determined that this rule is a "significant regulatory action" as defined in section 3(f) of the Order (although not an economically significant regulatory action under the Order). Any changes made to this rule as a result of that review are identified in the docket file, which is available for public inspection in the office of the Department's Rules Docket Clerk, Office of General Counsel, Room 10276, 451 Seventh Street, SW, Washington, DC 20410-0500.

Environmental Impact

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4223). The Finding of No Significant Impact is available for public inspection between the hours of 7:30 a.m. and 5:30 p.m. weekdays in the office of the Department's Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-0500.

Regulatory Flexibility Act

The Secretary has reviewed this proposed rule before publication and by approving it certifies, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), that this proposed rule would not have a significant economic impact on a substantial number of small entities. The reasons for HUD's determination are as follows.

First, the proposed rule would limit 203(k) rehabilitation loan insurance to one-unit structures. Over the last eleven years, approximately 80 percent of all 203(k) loans have been made for single unit structures. Accordingly, the economic impact on small lenders of limiting the program to one-unit structures would not be significant in comparison to the total number of 203(k) loans made. In addition, although 203(k) loan insurance would no longer be available for the rehabilitation of multi-unit structures, there are other FHA mortgage insurance products that can be used for the rehabilitation of such structures. For example, FHA's Title I program can be used to improve a multi-unit structure after purchase. Nothing in this proposed rule would preclude lenders participating in the

FHA programs from offering such alternate mortgage insurance products.

The proposed rule would also cap the total cost of rehabilitation to 20 percent of the HUD single family mortgage limit for a one-unit structure in a "high cost area." As noted above in this preamble, the average amount of rehabilitation on a 203(k) loan in Fiscal Years 1999 and 2000 was approximately \$29,000. Accordingly, HUD believes that the proposed rehabilitation cap of \$52,321 is appropriate to prevent the 203(k) Program from being used for overly complicated and expensive work, while continuing to serve the program's primary customer—homebuyers purchasing a one-unit structure in need of moderate rehabilitation.

Finally, as the HUD mortgage limits increase each year, the dollar amount of the proposed cap will also rise. For example, the FHA statutory single family mortgage limit for a one-unit structure in a high-cost area rose over 9 percent from 2001 (\$239,250) to 2002 (\$261,609).

HUD has taken other steps to help ensure that the proposed cap does not impose a substantial economic burden on either 203(k) lenders or borrowers. For example, the proposed cap would only include costs related to the actual rehabilitation of the property and would not include costs such as consultant fees, supplemental origination fees, the costs of preparing architectural exhibits, and contingency fees. Additionally, the cap would not include rehabilitation costs incurred to improve the energy efficiency standards of the home and six months of mortgage payments.

Notwithstanding HUD's determination that this rule will not have a significant economic effect on a substantial number of small entities, HUD specifically invites comments regarding any less burdensome alternatives to this rule that will meet HUD's objectives as described in this preamble.

Executive Order 13132, Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on State and local governments and is not required by statute, or the rule preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule would not have federalism implications and would not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments, and on the private sector. This proposed rule would not impose any Federal mandates on any State, local, or tribal governments, or on the private sector, within the meaning of the Unfunded Mandates Reform Act of 1995.

Catalog of Federal Domestic Assistance Numbers

The Catalog of Federal Domestic Assistance Number for the Section 203(k) Rehabilitation Loan Insurance program is 14.108.

List of Subjects in 24 CFR Part 203

Hawaiian Natives, Home improvement, Indians—lands, Loan programs—housing and community development, Mortgage insurance, Reporting and recordkeeping requirements, Solar energy.

Accordingly, for the reasons described in the preamble, HUD proposes to amend 24 CFR part 203 as follows:

PART 203—SINGLE FAMILY MORTGAGE INSURANCE

1. The authority citation for 24 CFR part 203 continues to read as follows:

Authority: 12 U.S.C. 1709, 1710, 1715b, and 1715u; 42 U.S.C. 3535(d).

2. Amend § 203.50 by revising paragraph (e) and adding paragraph (m) to read as follows:

§ 203.50 Eligibility of rehabilitation loans.

* * * * *

(e)(1) The loan transaction shall be an acceptable risk as determined by the Secretary.

(2) The Secretary has determined that loan transactions for the rehabilitation of two-, three-, and four-unit structures (other than those involving the conversion of such structures to one-unit structures) constitute an unacceptable risk.

* * * * *

(m) *Maximum cost of rehabilitation.* For purposes of paragraph (f) of this

section, the maximum cost of the rehabilitation shall not exceed 20 percent of the loan dollar amount limitation established by HUD pursuant to section 203(b)(2)(A) of the National Housing Act (12 U.S.C. 1709(b)(2)(A)) for a one-unit structure in a “high cost area.” This limit does not apply to:

- (1) Costs incurred to improve the energy efficiency standards of the property;
- (2) Six months of mortgage payments; and
- (3) Costs not directly related to the physical rehabilitation of the property, such as (but not limited to):

- (i) Consultant fees;
- (ii) Supplemental origination fees;
- (iii) The costs of preparing architectural exhibits; and
- (iv) Contingency fees.

Dated: July 8, 2002.

John C. Weicher,

Assistant Secretary for Housing—Federal Housing Commissioner.

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