



# FHA 203(K) Rehabilitation Loan Program

Renovating and Rebuilding America  
One Home at a Time

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The 203(k) loan is an FHA insured mortgage for the purchase or refinancing of a 1-4 unit residential and mixed use properties. The loan is fully funded in ten days after closing, can be insured before the construction is completed and an owner/occupant is eligible for a fixed or adjustable rate mortgage (ARM).

A wide variety of repairs and improvements can be covered, such as structural damage; additions; finishing attics and basements; remodeling bathrooms and kitchens; eliminating health and safety hazards like lead based paint; new siding; repairing or replacing of plumbing, heating, air conditioning and electrical systems; roofing; gutters and down spouts; flooring, tiling and carpeting; energy conservation improvements; landscaping and improvements for accessibility.

Any approved 203(k) lender can make a loan based on the estimated market value of the property after the rehabilitation is completed. Up to 110% of the completed value

The down payment investment is 3.5% of the acquisition and repair amount.

The first step in the process is to be pre-qualified.

A real estate agent can give you an estimate of the market value of the property after the work is completed. Then you will know what purchase price to offer the seller. You don't want the purchase price and the cost of repairs to be more than the property will be worth when it is completed.

If you want to refinance a home under a 203(k) loan, you should get a rough estimate of the cost of repairs and improvements. Then contact a real estate agent to get an estimate of the market value of the property after the work is complete.

The next step is to have an FHA/HUD approved Consultant prepare the Work Write Up "construction specifications ("Specs.") of the work to be performed on the building".

The 203K inspection includes a review of the bid from the contractor that has been selected to be sure it meets the specifications, and that it is priced within an acceptable budget. A 203K inspection costs are \$400.00 - \$1000.00, depending on the cost of the work that needs to be done.

When the consultant's specifications are completed, they are forwarded to the loan officer and the LO will then forward it to the appraiser upon ordering the appraisal. The appraiser will review the specifications, and complete the appraisal. The appraiser will issue an appraisal consisting of the "as is" and "the completed repairs value". Once the appraisal is completed, the lender will have the exact amount of the after improved value of the property. It is at this point that the lender is able to determine the final numbers of the loan.

While the appraiser is completing the appraisal, the lender is assembling the borrower's loan package including the 203(K) Maximum Work Sheet. When all the documents are in, the file goes to

underwriting for the final approval. All lender fees, most closing costs and the amount required for the repairs are all included in the mortgage amount. After the loan is closed, the funds required for construction are deposited into a construction escrow account, and are disbursed as the construction progresses.

When all the repairs are completed, any remaining construction escrow funds can be used for further improvements or it is applied back to the principal of the loan.

### **The Advantage of a 203(k) Loan**

- Homeowners or approved Non Profit corporations can Purchase or Refinance
- 3.5% down payment (on acquisition and repairs total)
- Finance All Allowable Closing Costs (Typical FHA Financing)
- One-to-Four Family units can be rehabilitated including Multi-Use properties (No more than 25% of commercial space)
- Up to Six Months to Complete the Rehabilitation
- Finance Up to Six Months of Mortgage Payments (no holding costs)
- Must Complete a Minimum of \$5000.00 in Repairs or Improvements (Full K)
- Loan amount may be based on up to 110% of "After-Improved Value"
- Eligible for Energy Efficient Mortgage Program

## Eligible Properties

1. Any one to four unit properties which have been completed with a certificate of occupancy for at least one year.
2. Homes that have been demolished or razed as a part of the rehabilitation process can be rehabbed as long as the existing foundation system remains. Repairs or additions may be done to the foundation in conjunction with the 203(k).
3. A home can be moved from an existing foundation to a new site and foundation. However, no money will be released from the escrow account until the foundation is properly inspected, and the home is satisfactorily attached to the new foundation including modular homes.
4. Any property the buyer wishes to convert either from single family into a two to four family or from a two to four family dwelling into a single family unit. A six unit property may be converted to four units or less and be eligible for a 203(k).
5. A manufactured home built AFTER June 15, 1976 and affixed to a permanent foundation for over one year. The unit must have been delivered to the site when it was new, prior to being occupied.
6. A 203(k) can be used on a "mixed use" residential property when it meets the following requirements:

The floor space used for commercial purposes does not exceed.....

25% for a one story building  
33% for a three story building  
49% for a two-story building

The commercial space can only be "Core and Shell". Funds cannot be used to "fit out" the space

7. A 203(k) can also be used on Condominiums subject to the following conditions:
  - \* Owner/occupant and qualified non-profit borrowers
  - \* Rehabilitation is limited only to the interior of the unit. Mortgage proceeds are not to be used for the rehabilitation of exteriors or other areas which are the responsibility of the condominium association, except for the installation of fire walls in the attic for the unit.
  - \* Only the lesser of five units per condominium association, or 25% of the total number of units, can be undergoing rehabilitation at any time.
  - \* The maximum mortgage amount cannot exceed 110% of after improved value

## ***Eligible Improvements***

There is a minimum requirement of \$5,000.00 in eligible improvements on the subject property. Improvements to a detached garage, a new detached garage, or the addition of an attached unit (if allowed by local zoning ordinances) can also be included in this first \$5,000.00.

**The mortgage must include one or more of the items listed below:**

- \* **Structural repairs and alterations.**  
Includes such items as additions to the structure: repairing any structural damage.
- \* **Improvement in the functionality or modernization.**  
Includes such items as remodeled kitchens and bathrooms.
- \* **Changes for aesthetic appeal, and the elimination of obsolescence.**  
New exterior siding, new doors and new windows. New detached garage.
- \* **Repair or replacement of plumbing, heating, air condition or electrical systems.**  
Installations of new plumbing fixtures are acceptable, including interior whirlpool bathtubs.
- \* **Installation of Well and/or Septic System.**  
Must be installed or repaired prior to beginning any other repairs to the property. Properties less than one acre in size can be limited on this item.
- \* **Replacement of flooring, carpeting or tiling.**
- \* **Energy conservation improvement.**  
New insulated windows and doors, storm windows, insulation, solar domestic hot water systems and solar panels
- \* **Major landscape work and site improvement.**  
Patios and terraces that improve the value of the property equal to the cost, or that are needed to preserve the property from erosion. Tree removal is also acceptable if the tree presents a hazard to the occupants.
- \* **ADA. Improvements for easier accessibility to the handicapped.**

**These items cannot be included in the first \$5,000.00 minimum requirement, but may be added:**

- \* New cooking ranges, refrigerators and other free standing appliances.
- \* Painting, carpeting and other cosmetic repairs.
- \* Repair of a swimming pool, up to \$1,500.00. Any costs exceeding \$1,500.00 must be paid into the contingency Reserve by the borrower.

**NOTE:**

- \* Items that will not become a permanent part of the property are not eligible.
- \* **No** luxury items are not eligible. These items include, but are not limited to: New swimming pools, exterior hot tubs, saunas, spas, tennis courts and barbecue pits.

**HOW IT ALL WORKS**

**The Buyer Locates a Home**

- \* One to four family dwelling
- \* Completed for at least one year
- \* Condominiums and mixed use properties are eligible

**Preliminary Feasibility Analysis**

The following must be determined:

- \* The extent of rehab required
- \* Rough cost estimates of work
- \* Expected market value after rehab

As long as the sum of the rehabilitation cost and purchase price (or existing debt) does not greatly exceed the value of comparable properties in the area, the project would be considered feasible.

### **Buyer Negotiates Contract**

- \* Pre-Qualifies Borrower

### **Consultant Prepares Work Write-Up and Cost Estimate**

- \* The consultant prepares the exhibits for the loan process
- \* If a plan reviewer acts as the consultant, the exhibit goes to the appraiser.

### **Lender Reviews Application**

- Appraisal is reviewed to determine the maximum insurable mortgage amount
- Lender issues Statement of Appraised Value.

### **Credit Package Submitted**

- Firm commitment is issued, if application found acceptable

### **Mortgage Loan Closing**

- Loan is closed, funded and an escrow account for rehabilitation is established.

### **Rehabilitation Begins**

- Homeowner has up to six (6) months to complete the work.



## **Releases from Rehabilitation Escrow Account**

As rehab progresses, funds are released after work is inspected by a HUD inspector. Ten percent (10%) is held back from each draw payment.

## **Completion of Rehabilitation/Final Inspection**

Hold back and any remaining funds in the escrow account are released.

## **203(k) Borrower's Acknowledgment**

At this point the buyer is just meeting with the loan officer. The first thing that needs to be addressed is the Borrower's Acknowledgment. It is very important that the buyer understands this document. It will explain the 203(k) loan program to them as follows:

- \* Condition of Property: This statement informs the buyer that the property is currently in need of minor/major repairs, and that a Plan Review and appraisal was performed to comply architectural exhibits and to estimate the value of the property, this does not guarantee that the property is free of defects. It also states that the repairs can be financed into the loan amount.
- \* Loan Requirements- All payments (including a contingency reserve, mortgage payments and other fees, where applicable) will be put into an interest bearing account. When the construction is completed the remaining interest will either be paid to the borrower, applied to the mortgage principal or other.
- \* The Rehabilitation Escrow Account will cease paying interest if the mortgage payments are more than 30 days delinquent or if the completion date has expired. At this point the interest will be used to pay down the mortgage principal. If the buyer clears up the delinquent or default the interest will begin again.
- \* No draws can be requested until all required permits are in place, where applicable. The buyer can only request monies for the actual cost of rehabilitation. If any saving occurs they can be used as follows; 1) To make further improvements, 2) Pay for cost overruns in other line items, 3) or to prepay the mortgage principal.
- \* The contractor is to complete the construction in a workman like manner, and the borrower is

to sign off on the draw request only if he approves to the work completed. The buyer and contractor also need to understand that there is a 10% hold back from each draw.

- \* If the buyer decides to change contractors he/she must understand that they may be obligated under the original terms of the contractor agreement. They should try to resolve their differences before terminating their contract, if possible.
- \* The buyer is responsible for any warranties on the construction. They can obtain these warranties from the contractors performing the work.
- \* The buyer is to understand that they are to make mortgage payments during construction, including the rehabilitation period, to ensure that the property will not go into default. If the construction is not started in 30 days or has stopped for over 30 days the mortgage company may find them in default, and the lender can use the escrow money to complete the construction. The lender may also require additional compliance inspections to protect the security of the loan. The buyer will be responsible to pay for the inspection, and the cost of this inspection could be withheld at the next draw.
- \* Changes can be made to the architectural exhibits by using HUD form 92577, with the DE lender's approval. This money comes out of Contingency Reserve and can be used for health and safety improvements or additional improvements can be made when it is determined that no other health and safety improvements exist.
- \* If there are unused contingency funds, mortgage payments, inspection fees or other monies in the Rehabilitation Escrow Account after the final release is processed, the lender, in compliance with HUD regulations, must apply those funds to prepay the mortgage principal. The lender may also hold the 10% hold back for no longer than 35 days to ensure compliance with state lien waiver laws.

## **203(k) Maximum Mortgage Worksheet**

Property Information

Rehabilitation and Other Allowable Costs

Mortgage Calculation for Purchase Transactions

Mortgage Calculations for Refinance Transactions

## Completing the Maximum Mortgage Worksheet

### Section Property Information

1. **Contract Sales Price or Existing Debt:**

The sales price of the property should be filled in this box. If the mortgage is being done as a refinance, then the existing debt on the property would be filled in this box.

\_\_\_\_\_A1

2. **“As-Is” Value**

This value will be determined by the sales price in most cases. If the DE Underwriter feels that an “As-Is” appraisal is necessary, then that value will be entered here. This amount represents the value of the property prior to any rehabilitation being done. Often in the case of a refinance, an as-is appraisal will be the best way to make the loan work out with the least amount of cash being paid out of the borrower’s pocket.

\_\_\_\_\_A2

3. **After-Improved Value**

This value will come from the 203(k) appraisal. This appraisal should represent the appraiser’s estimate of the property’s value after completing the proposed rehabilitation. This estimate is determined by the values of the other properties in the immediate area around the subject property in similar condition.

\_\_\_\_\_A3

4. **110% After-Improved Value**

This value is merely a calculation. It is the after-Improved Value multiplied by 110%.

\_\_\_\_\_A4

5. **Estimated Closing Costs**

This figure should come from the Good Faith Estimate. It should include items such as the origination fee, credit report and appraisal fees, mortgage tax, title search and insurance premium, and survey/re-certification fee.

\_\_\_\_\_A5

### Section B Rehabilitation and Other Allowable Costs

1. **Total Cost of Repairs** (Line 36, HUD-9746-A (1/94))

Once the signed Specification of Repairs has been reviewed and accepted by the Plan Reviewer, the Plan Reviewer signs a template Draw Request form (HUD-976-A) which lists the agreed upon totals of all the line items on the Specification of Repairs. The total on the Draw Request form (Line 36) will be filled in this line.

\_\_\_\_\_ B1

2. **Contingency Reserve on Repair Costs**

The Contingency Reserve is an additional escrow which is set up to protect the borrower from any unforeseen problems which could arise throughout the rehabilitation process. The moneys set aside for the contingency reserve can be used for health, safety and necessity items or for additional improvements once the rehabilitation is complete. This amount should be between 10 and 20% of the rehabilitation amount, and is determined by the DE Underwriter based upon the suggestion of the Plan Reviewer. If the utilities are off when the Plan Review is completed, then the contingency reserve should be 15%.

In cases where only the foundation remains and the rehabilitation will be primarily new construction, the DE Underwriter can waive this requirement.

The borrower can pay the contingency reserve amount in cash. In this case, any unused funds will be returned to the borrower when the rehabilitation is complete, If the borrower is paying the contingency reserve in cash, enter a "0" on this line.

\_\_\_\_\_ B2

3. **Inspection and Title Update Fees**

Inspection Fees

Please refer to the 203(k) Fee Schedule for information on Inspection Fees.

\_\_\_\_\_ Inspections x \$ \_\_\_\_\_ = \_\_\_\_\_

**Title Update Fees**

Please refer to the 203(k) Fee Schedule for information on Title Update Fees.

\_\_\_\_\_ Title Updates x \$ \_\_\_\_\_ = \_\_\_\_\_

Sum of Inspection Fees & Title Update Fees

\_\_\_\_\_ B3

4. **Mortgage Payments**

The borrower is permitted to escrow up to six months mortgage payments on a 203(k). This is allowed ONLY if the property is not occupied. Once the property becomes inhabited any

unused mortgage payments will pay down principal at the Final Release.

\_\_\_ Mortgage Payments x \$ \_\_\_ = \_\_\_\_\_ B4

5. **Subtotal for Rehabilitation Escrow Account** (Sum of B1-B4)

\_\_\_\_\_ B5

6. **Architectural and Engineering Fees** (Exhibits)

If there is going to be a structural modification to either the interior or exterior of the property, then the borrower may finance the fees charged by an architect to do the necessary drawings of the plans for the Plan Reviewer and Appraiser to review.

\_\_\_\_\_ B6

7. **Independent Consultant Fees**

In cases where the rehabilitation project is large, it is easier for the borrower to hire a consultant to help them determine what work should be done, and helping to obtain contractor bids, etc. These fees can be financed under the 203(k) program and should be shown on this line. When the independent consultant is also a fee panel reviewer, only the consultant fee is charged.

\_\_\_\_\_ B7

8. **Permits and Other Fees** (explain in Remarks)

All permit fees and other miscellaneous fees will be recorded in line B8.

\_\_\_\_\_ B8

9. **Plan Reviewer Fees**

If the buyer or contractor prepares the Specification of Repairs, the file must be reviewed by a Plan Reviewer. Please refer to the 203(k) Fee Schedule for information on the allowable Plan Review Fees. No plan review fee is charged when the approved Plan Reviewer is acting as the Consultant.

Plan Review Fee \_\_\_\_\_  
\_\_\_ miles @ \_\_\_ per mile + \_\_\_\_\_  
\_\_\_\_\_ B9

10. **Subtotal** of B5 thru B9

\_\_\_\_\_ B10

11. **Supplemental Origination Fee**

The supplemental origination fee is collected in addition to the percentage being charged on the total mortgage amount. It is calculated as 1 1/2% of the rehabilitation amount, or \$350.00 whichever is greater, and should be shown on this line.

\_\_\_\_\_B11

12. **Discount Points on the Repair Costs and Fees**

The discount points on the portion of the mortgage amount allotted to rehabilitation can be financed on a 203(k). The discount percentage should be multiplied by Line B10 and the product should be shown on this line. The following are some basic guidelines on financed discount:

- \* The number of discount points being financed on the rehabilitation costs cannot exceed those being charged on the total mortgage amount.
- \* The borrower does not have to finance the discount on any portion of the loan.

**“Points” of Interest**

- \* The discount points on the total loan should be shown on the Firm Commitment.
- \* The cash discount should be shown on the Mortgage Credit Analysis Worksheet.
- \* The financed discount should be shown on Line B12 of the Maximum Mortgage Worksheet, which is attached to the Mortgage Credit Analysis Worksheet.

\_\_\_\_\_B12

13. **Subtotal for Release at Closing**

(Sum of B6 thru B9) \_\_\_\_\_  
(Sum of B11 and B12) + \_\_\_\_\_

\_\_\_\_\_B13

14. **Total Rehabilitation Cost**

The amount of the total rehabilitation cost is used to determine the maximum mortgage amount. If the borrower chooses to pay any of the above referenced expenses in cash at closing, they are permitted to do so provided the amount is shown on the Maximum Mortgage Worksheet in parenthesis. Any amounts shown in parenthesis will be used to establish the escrow account, but should not be included in any subtotals or totals used to determine the maximum mortgage amount.

B5 \_\_\_\_\_  
B13 + \_\_\_\_\_

\_\_\_\_\_ B14

**Section C Mortgage Calculation for PURCHASE Transactions**

1. Lesser of sales Price (A1) or "As-Is" value (A2) or P.D. Contract Price

\_\_\_\_\_ C1

2. Total Rehabilitation Cost (B14)

\_\_\_\_\_ C2

3. Lesser of Sum of C1 + C2 or 110% After-Improved Value (A4)

\_\_\_\_\_ C1  
+ \_\_\_\_\_ C2  
\_\_\_\_\_ Total

OR

\_\_\_\_\_ A4  
(Whichever is less)

\_\_\_\_\_ C3

4. **Estimated closing Costs** (A5) + Allowable Pre-Pays for HUD-Owned Property

The estimated closing costs can be found on Line A5. This number should come from the good Faith Estimate and the Mortgage Credit Analysis Worksheet. Allowable Pre-Pays for a HUD-Owned Property would be any tax or insurance escrows that HUD permits to be financed. Such a provision would come from an incentive plan to sell the property, and will be specified in the sales contract.

\_\_\_\_\_ A5  
+ \_\_\_\_\_ Allowable Pre-Pays  
\_\_\_\_\_

\_\_\_\_\_ C4

5. **Maximum Mortgage Amount**

\_\_\_\_\_ C3  
+ \_\_\_\_\_ C4

OR x 97% (if under \$50,000.00)  
OR x 97/95% (if over \$50,000.00)



OR x 97/95/90 (if over \$125,000.00)  
 OR less Allowable Down payment (HUD-Owned Property)  
 \_\_\_\_\_ C5

6. **Borrower's Required Investment**

\_\_\_\_\_ C3  
 + \_\_\_\_\_ C4  
 - \_\_\_\_\_ C5  
 \_\_\_\_\_ C6

Section D **Calculation for REFINANCE Transactions**

1. **Sum of Existing Debt + Rehabilitation cost + Estimated Closing Cost + Discount on Refinance.**

\_\_\_\_\_ A1 (Existing Debt)  
 \_\_\_\_\_ B14 (Rehabilitation Cost)  
 \_\_\_\_\_ A5 (Estimated Closing Cost)

The discount on the refinance is calculated by multiplying the number of discount percentage points by the existing debt. The discount on the repairs is calculated and added to the loan on Line B12.

\_\_\_\_\_ % on \$ \_\_\_\_\_  
 + \_\_\_\_\_ (Discount on Refinance)  
 \_\_\_\_\_ D1

2. **Lesser of "As-Is" Value + Rehabilitation Costs OR 110% After-Improved Value.**

\_\_\_\_\_ A2 (As-Is Value)  
 + \_\_\_\_\_ B14 (Rehabilitation Costs)  
 \_\_\_\_\_  
 OR  
 \_\_\_\_\_ A4  
 (Whichever is less)  
 \_\_\_\_\_ D2

3. **Estimated Closing Cost (A5)**

\_\_\_\_\_D3

4. **Sum of D2 + D3 97/95/90% (Owner-Occupant)**

\_\_\_\_\_D2  
+ \_\_\_\_\_D3

OR x 97% (if under \$50,000)  
OR x 97-95% (if over \$50,000)  
OR x 97/95/90% (if over \$125,000)

\_\_\_\_\_D4

5. **Maximum Mortgage Amount:** Lesser of D1 or D4, not to exceed Statutory Amount

\_\_\_\_\_D1

OR

\_\_\_\_\_D4  
(Whichever is less)

\_\_\_\_\_D5

6. **Borrower's Required Investment (0) or (D2 + D3 - D5)**

\_\_\_\_\_D2  
+ \_\_\_\_\_D3  
- \_\_\_\_\_D5

\_\_\_\_\_D6

**HUD Approved Independent Consultant**

A HUD Approved Independent Consultant can prepare the architectural exhibits for the borrower. No further "Plan Review" is necessary other than a lender review. The Independent Consultant can charge from \$400 to \$1000 for this service depending on the Scope of Repairs. No Plan Review Fee is charged.

**HUD Fee Plan Reviewer**

A HUD Fee Plan Reviewer can act as a consultant to the borrower. No further "Plan Review" is necessary other than lender review. The Plan Reviewer can charge from \$400 to \$1000 for this service depending on the Scope of Repairs. No Plan Review Fee is charged.

Any Contractor, Engineer, Borrower can complete all the documents required. However, their work must go through a plan review.

If the Borrower can have a complete package prepared using their own resources, a HUD Fee Plan Reviewer must still perform an on-site inspection and "certify" the plans.

- \* In this case, the HUD Fee Plan Reviewer charges a Plan Review Fee of 200.00 to \$400.00. The fee will vary depending on the Scope of Repairs, but should be significantly less than if the Plan Reviewer operated as a consultant.

### **203K Consultant Fee Schedule**

Due to the nature of the 203(k) program, there are a number of fees which the borrower will incur throughout the completion of the rehabilitation. To save the borrower the immediate expense, HUD has made provisions which allow for various fees to be financed. When these fees are financed, they cause an increase in the mortgage amount. Guidelines have been established to what fees can be charged.

### **Inspection Fees**

For each Draw Request the lender is required to obtain a Compliance Inspection Report stating that the work for that particular draw has been satisfactorily completed. The HUD accepted Consultant is permitted to do inspections because he/she will already be familiar with the rehabilitation being done on the property. The following are guidelines as to how much the Consultant can charge to complete these inspections.

- \* Inspection fees are set at \$200.00 for one unit and \$25.00 per additional unit.
- \* Any unused inspection fees that are escrowed will be used to pay down on the principal once the rehabilitation is complete or can be used for additional improvements.
- \* If the inspection fees required to ensure compliance exceed the amount that was initially escrowed, the borrower or contractor will be responsible for payment, at the time of the inspection.

## **Title Update Fees**

In order to ensure that the mortgage position remains intact on the title, a title update and lien waiver is required prior to any Draw releases. The maximum amount allowed to be financed for any title updates is \$75.00 per draw, and any unused moneys will be used to pay down the principal on the mortgage amount once the rehabilitation is complete.

## **203(k) Consultant Fees**

The 203(k) Consultant should inspect the property and provide all the architectural exhibits required for this fee. Architectural and engineering fees are not restricted by this fee schedule and should be shown on Line B6 of the Maximum Mortgage Worksheet, as long as they are customary and reasonable for the type of project being done. The allowable consultant fees should fit within the following parameters:

Cost of Repairs	Fee
< \$7,500.00	\$400.00
< \$15,001.00	\$500.00
< \$30,001.00	\$600.00
< \$50,001.00	\$700.00
< \$75,001.00	\$800.00
< \$100,001.00	\$900.00
> \$100,000.00	\$1000.00

## **Change Orders**

A change order is a form used to release monies from the Contingency Reserve. A change order is used for following different purposes:

1. for health and safety improvements
2. for additional improvements (only to be done when 90% completed with the construction).
3. Delete monies out of the Specification of Repairs into the Contingency Reserve.

Change orders can also be used for the following reasons:

1. If there is a problem with the contractor you would want to use a change order to release the current contractor, and then bring in the new contractor to complete the remaining work.
2. You also can use the Change Order form to ask for extensions on the construction work due to unforeseen delays.

## **Contingency Reserve**

Since nobody is perfect, we have Contingency reserve. The Contingency Reserve is funds that are set aside for unforeseen health and safety hazards or for additional repairs/desired items.

The contingency reserve is an amount of money that is set aside over and above the repair cost estimates. The 203(k) program requires a minimum of 10% and a maximum of 20% contingency reserve. This percentage is developed based on the Consultants concerns regarding possible additional repair items that may show up after construction has commenced.

### **Example:**

One thing that I am sure of is that a consultant cannot see through walls any better than a home inspector. Let's say the Consultant has specified that all the outlets be replaced, maybe because they are paint covered. It is assumed during the inspection that the wiring was okay because there was no visible evidence of any problems. The Consultant has specified \$20 per outlet for 10 outlets totaling \$200. Once the contractor replaces the outlets and charges up the electrical system, he or she finds that five of the outlets have no power. Now the contractor wants and deserves additional money to re-wire the outlets. This is when a change order is written up authorizing a release of contingency reserve funds to compensate the contractor for the additional work items.

Contingency reserve monies can also be used for additional desired items. When the construction process has progressed to approximately 80 to 90% complete, contingency reserve monies can be released for additional work items, or for upgrades. However, contingency money can be released before the construction is 80 to 90% complete if it is needed for some type of health and safety item. Contingency reserve monies can only be released for additional work items or up-grades. It cannot be used for contractor cost over runs.

When you design the percentage of contingency you or the Consultant should take into consideration:

- A. The size of the job.
- B. Possible potential problems.

### **Example:**

If you have an \$8,000 kitchen job specified, is 10% or \$800 adequate to address any problems that may arise? Or would you feel more comfortable with \$1,600 or 20%?

**Example:**

If you have a \$150,000 gut rehab at 10% your contingency reserve would be \$15,000 at 20% it would be \$30,000. The question you would want to ask yourself is, "What is out there that can cost over \$15,000 to repair?" On a gut rehab probably not much. When you look at a gut rehab, your main concern is the underground utilities because you know everything is going to be new.

**Draw Request**

For the first Draw Request the buyer should contact the mortgage company to let them know that they are ready for their first Draw. You will want to advise the buyer to contact their HUD approved inspector to place a Draw inspection. At this time the underwriter will order a title update to make sure there were no liens put on the property.

After the inspection has been completed and the mortgage company has the original draw in the office, it will go to the DE Underwriter for approval. On the first Draw Request the DE Underwriter needs to make sure that the property has the required permits for the work being performed. On all Draw Requests they need to fill out their accounting worksheet, collect any lien wavers from the contractor or receipts from the buyer.

The accounting worksheet states how much money has been released on each draw, the amount of inspections used, how many title updates have been used, the 10% hold backs, any change orders and whether or not they have been released.

After the DE Underwriter approves the Draw Request it is then sent to the investor for their approval. Once the Draw is sent to the investor they have 48 hours to give approval for the check to be cut.

The check can be sent to the title company or directly to the lender for disbursement.

**Contractor Responsibilities**

Having determined that there is a need to educate the contractors that show a willingness to participate in the 203K program. Nobody has advised the contractor about the roles and responsibilities of the contractor. The major topics that the contractor needs to understand are as follows:

1. The contractor works directly for the borrower however, the contractor cannot perform any additional repairs without having a change order approved in advance. Anything that will affect the contractors billing must be approved before the work is started.

- i. A change order can be approved for any items that effect health or safety concerns at any point in time. Additional work items or up-grades will not be approved until the job is 80% to 90% complete.
2. The Consultant and the contractor must work together to accomplish the desired goals. You should advise the contractor that he should contact the consultant if he has any questions.
3. There is no upfront or deposit money in the Full 203K program. The contractor must fund all the repairs until the first draw.
4. The amount of required draws is decided between the contractor and the Consultant. A \$7500 job may require two draws or a \$150,000 may require 5 draws. The amount of draws depends on the financial capacities of contractor. However, each draw will cost the borrower a minimum of \$200.00, plus a title-up date fee.
5. The contractor will need to be licensed and insured (if local laws require licensing). They will also need to provide Builders Risk Insurance to protect the borrower from losses during construction. The contractor is responsible for the security of the job site until completion. The homeowner's policy will not cover any items until the building is occupied.
6. The contractor will be given a specific amount of time to complete the repairs. Construction continuity must be maintained.
7. The contractor will be paid based on a percentage of completion and they may call for a draw at any point in time. If \$5,000 has been specified for new drywall and it is 50% complete, the inspector will approve \$2,500 for release. The inspector will not release any money for any items that are not installed and functioning. No money can be released if the item is not completely installed and in working order. Change orders can be paid out when the individual line items are 100% complete.
8. Building permits are required under the 203K program. No money will be released unless a permit has been obtained, and is in the window.
9. Substitution of materials will be allowed only if they meet or exceed the materials specified in the work write-up. Materials should be defined as economy grade, builder grade or custom grade.
10. No work can begin until the loan closes. The property does not belong to the borrower until after the closing.