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Refinancing for Renovations

The FHA's 203(k) loan program can help with home-improvement projects

With the traditional move-up market impacted negatively by foreclosures and short sales, many homeowners who would normally be moving to a new house may decide to stay put and improve the house they already own. For those homeowners who can't pull enough cash out of their house in a traditional refinance or self-finance their renovation project, mortgage brokers and loan originators can present another opportunity to meet home-improvement objectives: the Federal Housing Administration's (FHA's) Section 203(k) loan.

Many brokers know this program can be used to purchase and renovate distressed properties, but they may not realize that existing homeowners often can use the FHA's 203(k) loan to finance a home-improvement project. In fact, with the 203(k) loan, homeowners often can consolidate their existing mortgage loans and the cost of the home-renovation project into one new loan of as much as 97.75 percent of the home's after-completed value, which takes into consideration all the improvements that will be made to the property through the 203(k) loan's renovation budget.

By using the home's after-completed value, homeowners can be eligible for a larger renovation budget than those offered through a traditional mortgage loan or home-equity line of credit (HELOC). Traditional loan programs usually use the home's current value, without considering future improvements, to establish the maximum loan-to-value ratio (LTV).

Because the 203(k) refinance program allows homeowners to borrow 97.75 percent of the after-completed value to make improvements to a property, in addition to

rolling in all closing costs and escrows, it offers homeowners greater borrowing capacity than any other program currently available. Based on today's ultraconservative lending standards, the maximum LTVs allowed in a cash-out transaction are:

- **Conforming/conventional:** 85 percent;
- **FHA:** 85 percent;
- **U.S. Department of Veterans Affairs:** 90 percent; and
- **HELOC:** Typically 80 percent of the combined LTV (CLTV), including the existing first-trust mortgage.

The FHA 203(k) refinance program's benefits extend beyond having the highest LTV or CLTV of any currently available loan program. Consider these other benefits:

- **No appraisal-deficiency-related challenges.** If an appraiser identifies any problems, those issues usually can be included in the renovation project. This differs from other loan programs, which typically require the deficiency to be repaired prior to settlement.
- **Stable, 30-year fixed interest rate,** as opposed to an adjustable HELOC
- **Closing costs and escrows can be rolled into the new loan,** potentially allowing the homeowner to not need any cash at settlement.
- **Minimum credit score of 620 to 640,** depending on the investor, which is the least-restrictive credit score required of today's major loan programs

When discussing this loan program with prospective clients or with referral partners, such as general contractors, brokers should be aware of numerous potential challenges that may arise when processing the loan. For instance, the existing loans' relationship to the property's as-is value cannot



Illustration: Dennis Wurster

exceed 97.75 percent without the homeowner bringing money to the settlement table. So regardless of the project's after-completed value, if homeowners don't have a 2.25-percent equity stake in the property before work starts on the house, they must account for this difference at settlement.

Also, if receiving referrals from general contractors, make sure there is a net

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David Zuckerman is a branch manager and mortgage banker with WestStar Mortgage Inc. Zuckerman has been a licensed loan officer since 2003 and specializes in originating government-backed loans for first-time homebuyers. To help clarify the Federal Housing Administration's Section 203(k) loan program, Zuckerman launched www.rehab203kloan.com, a premier source of information for consumers contemplating a renovation mortgage loan. Reach him at info@rehab203kloan.com or (410) 522-5912.

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tangible benefit to the homeowner. For projects of less than \$10,000, contractor clients have access to “signature loans,” which are unsecured personal loans. If the homeowner doesn’t qualify for a signature loan and the contractor is recommending a 203(k) loan instead, make sure you consider the interest-rate and closing-cost benefit to the borrower on the transaction.

This program isn’t for all contractors. Because the FHA 203(k) loan is a government-backed program, contractors must be approved by the lender and must be licensed and bonded; carry general-liability insurance; and submit a 203(k) loan package to the lender.

Contractors on a 203(k) loan program also should be fully educated on the draw or repayment schedule they must follow. Unlike typical home-improvement projects in which contractors are paid a certain

percentage of the project in advance, a 203(k) loan requires that work must be done before contractors are paid. For contractors with limited financial resources, this can be a major challenge.

For contractors who can get past this cash-flow challenge, however, the transaction can be lucrative. For contractors not familiar with the FHA 203(k) loan program, loan originators should explain that the lender is approving the contractor as part of the loan approval. After the loan is approved, the homeowner cannot select a different contractor without lender approval. This will protect contractors and ensures they are paid directly by the lender for all work completed on the project based on a predetermined draw schedule. And because this is a government-insured loan program, there is virtually no chance of payment default,

provided the contractor complies with FHA guidelines.

Brokers also can work with clients and contractors to determine the loan terms. Most loan-origination software packages include a calculator function to help homeowners determine:

- **Their total rehabilitation budget;**
- **The final 203(k) refinance loan amount;**
- **If they must speak with an FHA 203(k) consultant;**
- **If they must bring any cash to close; and**
- **What their monthly mortgage payment, including escrow, will be.**

Brokers who familiarize themselves with the FHA 203(k) program can find more opportunities to help clients who don’t qualify for a traditional cash-out refinance in today’s market. By helping clients finance home-renovation projects, brokers can build their business. ●