How Do We Rehabilitate the FHA's 203(k) Rehabilitation Program?

Laurie Goodman, Ted Tozer, and Michael Neal

April 2023

The US housing stock is aging rapidly; the median one-to-four-family home in the United States was built in 1978. Only 23.8 percent of the housing stock was built in 2000 or after, 24.4 percent was built from 1980 to 1999, another 24.4 percent was built from 1960 to 1979, 16.9 percent was built from 1940 to 1959, and 10.6 percent was built in 1939 or earlier.[1]

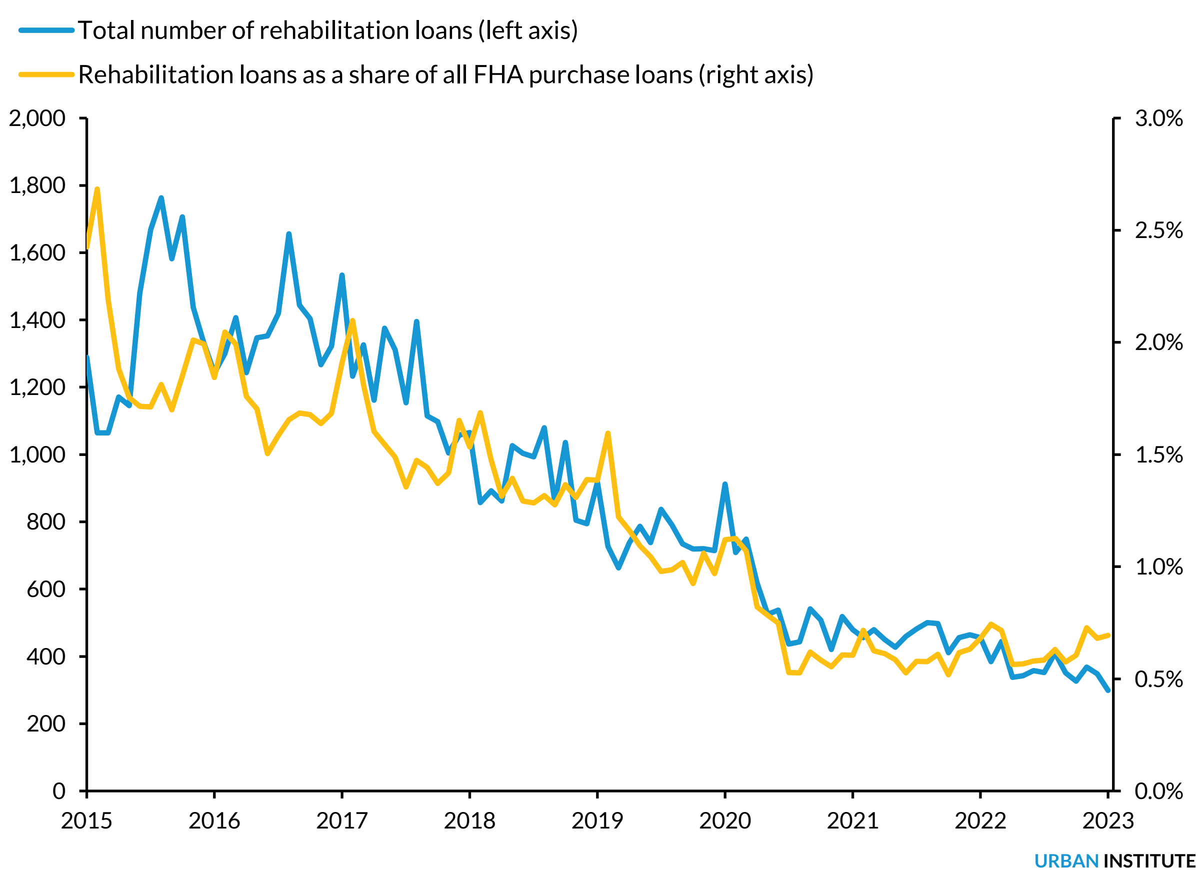
Meanwhile, we face an acute nationwide housing supply shortage. In the aftermath of the financial crisis, for-sale residential construction plummeted. And although the pace of this construction has improved since the lows set in the early 2010s, it has not returned to previous levels (Neal and Reynolds 2021). The below-normal pace of construction for an extended period has created today's housing supply shortage. Parrott and Zandi (2021) show that we are 1.7 million unit short; Khater, Kiefer, and Yanamadra (2021) show a shortage of 3.8 million units; and Rosen and coauthors (2021) show a shortage of 5.5 million units. This aging housing stock in combination with the acute housing supply shortage highlights the need for effective rehabilitation financing programs. There are approximately 142 million housing units in the United States, of which 107 million are one-to-four-family units.[2] If we could slow obsolescence by 0.1 percent per year, we would "save" 107,000 units per year. This would be a significant addition; in 2022, just over 1 million one-to-four-family units were built.

Homeowners making home improvements often use cash-out refinancing or a home equity line of credit. Only homeowners, not homebuyers, can use these vehicles. In addition, a cash-out refinance or home equity line of credit can be used to finance only up to 80 percent of the home's value before the repairs. If financing is needed to buy a home that needs repairs, or the borrower needs cash for repairs that requires the home estimate to be based on the home's market value after the repairs, they will need a renovation loan. These loans are offered by the Federal Housing Administration (FHA), the US Department of Veterans Affairs, and the government-sponsored enterprises.

The FHA rehabilitation financing program, 203(k), is a well-intentioned and much-needed program, but very few loans are made. For all of 2022, 4,478 loans were made, or 373 per month. This represents 0.5 percent of total FHA origination. In January 2023, the last month for which we have available data, 299 loans were made. Figure 1 shows these numbers have always been small and have been declining. Between 2015 and 2017, the number of FHA rehabilitation loans originated per month averaged 1,330. An average of 939 loans per month were originated in 2018 (1.2 percent of total FHA production), 757 in 2019, 576 in 2020, 463 in 2021, and 373 in 2022. Most of these loans are for the purchase of homes that need repairs, not for refinancing; from 2018 to 2022, less than 10 percent of the loans were for refinancing. Even if we look at purchase loans, rehabilitation purchase loans represent a tiny portion of this activity. The share contracted from 1.9 percent of total origination in 2015 to 0.6 percent in 2022. The reason for the low production is, in large part, that the program is cumbersome; hence the motivation for the US Department of Housing and Urban Development (HUD) issuing a request for information regarding rehabilitation mortgages.[3]

FIGURE 1

Originated FHA Rehabilitation Loans



Source: Urban Institute calculations of FHA data.

Note: FHA = Federal Housing Administration.

Renovation financing is tricky and expensive. Although government-sponsored enterprise programs are more popular than FHA programs, neither Fannie Mae's HomeStyle Renovation nor Freddie Mac's CHOICERenovation or CHOICERenovation eXPress do anything close to the volume of business that they should. There is a misalignment of incentives and expertise. The borrower generally does not have the necessary knowledge to judge how much the renovation will cost or to oversee the renovation, and they need professional help. Lenders are not construction experts. Coordination and timing are difficult, particularly for purchase loans, as the entire package must be assembled before the borrower can confidently bid on the property—or face a high denial rate. The result is that homes that need repairs are disproportionately going to investors, as investors have the expertise in determining what repairs are necessary and what they should cost before bidding on the home, they can negotiate volume discounts on labor and materials, and they can more easily obtain financing.[4] The difficulties with renovation financing are not uniquely an FHA 203(k) issue.

The Issues with the 203(k) Program

The 203(k) program has two forms: a limited form, where the borrower can take up to $35,000 for nonstructural repairs, and a standard form, which does not have a repair cost limit (apart from FHA loans limits) but requires a HUD consultant to oversee the process. The distinguishing feature of a rehabilitation financing program is that, when determining the mortgage's loan-to-value ratio, the property is measured based on the after-repair market value. It is likely that many borrowers do rehabilitation work on their home as part of their cash-out refinancing, where the value of the property is based on the before-repair market value; these loans are not part of the 203(k) program.

We do not have a breakdown between the limited program and the standard program. In the limited program, the hassle factor is small, and the money is disbursed up front. No HUD consultant is required. But the $35,000 maximum and the requirement that there be no structural repairs limits the program's value. The standard program, which requires a HUD consultant, is cumbersome, and relatively few lenders participate. In fact, most of the FHA's largest lenders do not participate in this program.

When asked why they do not participate, lenders cite the difficulties in implementing the program and the increased costs per loan. The process is as follows:

The lender first qualifies the borrower, as they would on any loan. But renovation financing has additional steps. The borrower must find a HUD consultant and a contractor. The consultant looks at the list of renovations for feasibility and makes sure the contractor bids are feasible. There is a shortage of these consultants. Even though the consultants know they will be paid, some who are qualified to be consultants do not want to participate in the program. Moreover, lenders do not think they can recommend particular contractors, as they believe they will be liable if the contractor does not do their job. A project plan and schedule of disbursements is drawn up. At this point, the appraisal is completed. All this must be done before the financing is approved.

When the work is under way, the lender is responsible for scheduling the HUD consultant to return to do an inspection certifying that the work has been completed properly before the money is disbursed.

The lender is also responsible for disbursing the money. And every draw requires a title update to make sure there are no new liens, and the contractor must attest that all bills have been paid.

This process requires careful coordination up front. The borrower should not bid on a home until they are sure about the full cost of the repairs and can finance these repairs. The seller may be reluctant to sell their home to a buyer using a 203(k) mortgage, as the denial rate is high. Using 2020 and 2021 Home Mortgage Disclosure Act data, we calculated a denial rate of 26.7 percent on these loans, versus 16.8 percent on all nonrehabilitation FHA lending (figure 2). The denial rate on conventional rehabilitation loans is even higher (37.1 percent).

TABLE 1

Denial Rates, 2020 and 2021

	Conventional	FHA	VA
Home improvement loans	37.1%	26.7%	26.8%
Non–home improvement loans (purchase + refinance)	12.5%	16.8%	13.0%
Purchase loans	11.0%	12.4%	8.2%
Refinance loans	13.3%	22.1%	15.1%

Source: Urban Institute calculations of Home Mortgage Disclosure Act data.
Note: FHA = Federal Housing Administration; VA = US Department of Veterans Affairs.

The HUD consultant should be hired before the borrower bids on the property but must be hired before the financing can be completed and the contractor bid is accepted. Firms that have successfully originated 203(k) loans have indicated that originating loans through their retail network with 203(k)-trained loan officers was critical to profitably using the 203(k) program. From the lender's perspective, if the HUD consultant, the contractor, and the loan officer do not work together to put together a financing package for the homebuyer, it makes the TRID (TILA-RESPA Integrated Disclosure Rule) disclosures cumbersome. One lender told us they normally make one or two changes on the TRID for an FHA loan but can make seven or eight changes on 203(k) loans, as the estimates for repairs change; this makes the loan more costly to originate. This problem can be avoided if (1) the HUD consultant and the contractor are lined up before the bid on the home is submitted, ensuring the bid is consistent with the repairs that would be required, and (2) only one pass at the TRID form is required; lenders who specialize in 203(k) lending encourage this.

These up-front costs become even more meaningful when considering loan size. The median loan size for a rehabilitation loan is slightly smaller than the FHA median. For example, in January 2023, the median rehabilitation loan was $256,000, and the median for all single-family loans was $273,000. From 2015 to January 2023, the median loan size was $200,000 for all loans and $183,000 for rehabilitation loans.

Several items do help with the process, and two are programmatic. First, of the few lenders that engage in 203(k) lending, one mentioned that there are software packages, available for a fee, that can save time in assembling these bids; these packages are cost effective for 203(k) lenders that do a lot of this lending. Second, the FHA allows for the cost of the home plus the construction to be up to 110 percent of the appraisal. Third, lenders find the contingency reserve helpful, as cost overruns often emerge, and this provides the necessary flexibility.

The loan is also more costly to service, as the lender is responsible for scheduling the inspections and disbursing the funds. The originators that do many of these loans tend to hire a full-time person to handle these tasks, providing better customer service and increased operational efficiency. Thus, it is no surprise that this financing is more concentrated than normal mortgage lending, with the top originators handling more than 10 percent of the total monthly volume apiece (25 to 30 loans per month).

Lenders who originate the product claim they can make it work financially by using premium pricing; they increase the note rate an extra 25 to 50 basis points for these loans. They can sell the higher coupon into the market and recoup their additional costs up front. In addition, the servicers can charge a fee for processing disbursements. The lenders who do not originate the product say they cannot make it work financially; though they can realize the benefit of the premium pricing, the servicing is often a short-lived asset. The loans are usually refinanced at the end of the renovation period (generally 6 to 12 months), as the 203(k) rates are higher. Certainly, the small number of originators (157 out of 1,786 Ginnie Mae issuers in 2021) indicates there is a compensation and lender infrastructure issue.

Within the confines of the program as it currently stands, three policy actions would make sense.

- The shortage of HUD consultants needs to be addressed. One way is to raise allowable payments to the HUD consultants to attract more of them. An alternative is to allow for a third-party inspector to step in if no HUD consultant is available.
- Raise the allowable fees on origination and for servicing the draws to make it more attractive for lenders to originate these loans. Currently, the maximum up-front origination fee on a 203(k) loan is 1.5 percent versus 1 percent for a traditional purchase or refinance loan.
- Raise the limit on the limited form of this program from $35,000 to $50,000, and index it for inflation.[5] The $35,000 limit has not been changed since 2009. Meanwhile, consumer, producer, and home prices have risen significantly since 2009. Additionally, allow the financing of consultant fees in the streamlined program. Consultants perform an important function to help homebuyers through the rehabilitation process. For amounts over the $35,000 threshold, HUD may want to encourage borrowers to work with a consultant.

In our discussions, although there was complete agreement on the first recommendation and widespread agreement on the second, many lenders did not like the third recommendation. They were concerned that (1) without requiring a HUD consultant, contractors would lowball the repair cost and then either do the work in an unsatisfactory fashion or increase the final cost to the borrower above their bid, or (2) the lender was possibly liable for repairs that were not completed properly or did not appraise out. If the loan limits on the streamlined program were to be raised, which we recommend, we have included a few features to address these lenders' concerns. For loan amounts over some threshold, encourage borrowers to work with a HUD consultant, and finance the consultant fees.

HUD may also want to consider introducing some accountability for contractors. Contractor registration makes sense; if a contractor does a poor job on several projects, that contractor should not be permitted to bid on future projects. The US Department of Veterans Affairs requires contractor registration in its renovation program.

More Fundamental Reforms Are Needed If the Product Is to Become More Than a Niche Offering

As we look at this program, the suggestions provided above can help, but to make this more than a niche product, the program will need a major overhaul. The real issue is that the borrower does not have the knowledge to judge which repairs are cost effective, the lender is not a construction expert, and program design must be such that the FHA or the government-sponsored enterprises finance projects that are comparable with their regular financing (or perhaps a bit more risky but not a lot more risky). We have come up with a solution to increase the use of this program. The solution centers on making it more "turn key" for the borrower and less complicated for the lender. But the contractor must absorb more of the risk. In exchange, we suggest that the contractor receive "preferred vendor status."

In our reimagined construct, the FHA contracts with several preferred vendors in a given geographic area. When the buyer is contemplating a purchase plus renovation or a refinancing plus renovation, they go to one of the preferred vendors. The preferred vendor scopes out the work and gives the borrower a fixed price that cannot be increased. The borrower goes to the lender with the preferred vendor's estimate and seeks financing. The lender qualifies the borrow and orders the appraisal. There is only one disbursement.

1. Before that disbursement occurs, the appraiser who performed the initial appraisal will certify that the rehabilitation work is complete and the projected value has been achieved.
2. The title update is completed, which requires the contractor to certify that all bills have been paid to subcontractors and suppliers, and once the draw is dispersed, there will be no claims against the property or homeowner.

As a preferred vendor, the contractor will be likely to receive a fair amount of work under this program. They will experience cost overruns on some projects, but there will be others where they will come in under cost. This aligns interests, as the contractor is responsible for completing the work to a satisfactory standard to get paid.

We can also consider a minor variation of this—the contractor is paid in full up front and is then responsible for completing the work and paying the subcontractors and suppliers. This would require a higher level of prequalification as a preferred vendor.

In short, the barriers to producing affordable housing remain and will likely continue for the foreseeable future. Changes can be made to make the 203(k) program less cumbersome, but barring a major change, it will remain a niche product. That will limit the effectiveness of a tool that otherwise could help resolve one of the key challenges of our time.

Notes

[1] Authors' tabulations from 2021 one-year American Community Survey data.

[2] 2021 American Community Survey.

[3] Request for Information Regarding Rehabilitation Loans, 88 Fed. Reg. 9529 (Feb. 14, 2023).

[4] Laurie Goodman and Edward Golding, "Institutional Investors Have a Comparative Advantage in Purchasing Homes That Need Repair," *Urban Wire* (blog), Urban Institute, October 20, 2021, https://www.urban.org/urban-wire/institutional-investors-have-comparative-advantage-purchasing-homes-need-repair.

[5] When indexing, policymakers should consider whether producer inflation is a more relevant measure than consumer inflation. That is, the intent should be to index the limit as closely as possible to the cost of residential construction, which can rise faster than shelter costs or the Consumer Price Index.

References

Khater, Sam, Len Kiefer, and Venkataramana Yanamadra. 2021. "Housing Supply: A Growing Deficit." McLean, VA: Freddie Mac.

Neal, Michael, and Liam Reynolds. 2021. *Housing Supply Chartbook: December 2021*. Washington, DC: Urban Institute.

Parrott, Jim, and Mark Zandi. 2021. "Overcoming the Nation's Daunting Housing Supply Shortage." Washington, DC: Urban Institute.

Rosen, Kenneth T., David Bank, Max Hall, Scott Reed, and Carson Goldman. 2021. "Housing Is Critical Infrastructure: Social and Economic Benefits of Building More Housing." Berkeley, CA: Rosen Consulting Group.

About the Authors

Laurie Goodman is an Institute fellow and founder of the Housing Finance Policy Center at the Urban Institute. The center provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial, Arch Capital Group Ltd., and Home Point Capital Inc. and is a consultant to the Amherst Group. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University

Ted Tozer is a nonresident fellow in the Housing Finance Policy Center. Immediately before joining Urban, he was a senior fellow at the Milken Institute's Center for Financial Markets. Previously, Tozer was president of Ginnie Mae for seven years, bringing with him to the institution more than 30 years of experience in the mortgage, banking, and securities industries. As president of Ginnie Mae, Tozer managed Ginnie Mae's nearly $1.7 trillion guarantees of mortgage-backed securities and more than $460 billion in annual issuance. He also led the modernization effort of the Ginnie Mae Securitization Platform. Tozer oversaw the transition for a depository-dominated issuer base to an independent mortgage banker–dominated base. He was the Obama administration point person for rewriting the Home Affordable Refinance Program. Tozer also oversaw the transition from the Ginnie Mae I program to the Ginnie Mae II program. Before joining Ginnie Mae, he was senior vice president of capital markets at the National City Mortgage Company (NCM) for more than 25 years, overseeing pipeline hedging, pricing, loan sales, loan delivery, and credit guideline exceptions. He was instrumental in transforming NCM from an originate-and-hold lender to an originate-and-sell lender. Tozer also serves on the board of directors of PennyMac Financial Services, a mortgage originator. He holds a bachelor's degree in accounting and finance from Indiana University.

Michael Neal is a principal research associate and Equity Scholar at the Urban Institute. Previously, he worked at Fannie Mae, where he was a director of economics in the Economic and Strategic Research group. Before his service at Fannie Mae, Neal was the assistant vice president at the National Association of Home Builders' economic and housing policy department. As a housing economist, Neal has an in-depth knowledge of housing market trends and has provided expert analysis and commentary on housing to media outlets around the country. Previously, Neal worked for Congress's Joint Economic Committee, the Federal Reserve System, the Congressional Budget Office, and Goldman Sachs. Neal has a bachelor's degree in economics from Morehouse College and a master's degree in public administration from the University of Pennsylvania.

Acknowledgments

This brief was supported by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

500 L'Enfant Plaza SW
Washington, DC 20024

www.urban.org

ABOUT THE URBAN INSTITUTE

The Urban Institute is a nonprofit research organization that provides data and evidence to help advance upward mobility and equity. We are a trusted source for changemakers who seek to strengthen decisionmaking, create inclusive economic growth, and improve the well-being of families and communities. For more than 50 years, Urban has delivered facts that inspire solutions—and this remains our charge today.

Copyright © April 2023. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban Institute.