



Effectively Managing Renovation Lending Risks

Mitigating Renovation Construction Lending Risks

Rehab Lending

- **FHA 203(k):** HUD's primary program, a home improvement loan program used for community and neighborhood revitalization and expanding homeownership opportunities.
- **FHA 203(k) Streamlined:** A modification of 203(k) to facilitate purchase where property needs minor rehabilitation work
- **FannieMae Homestyle Renovation:** allows qualified buyers to refinance mortgage transactions including owned property

Purchase Home
Install New Windows

Purchase Home
Tear Down Structure,
Rebuild New Home



Low Risk

High Risk

Rehab Construction Lending Risk

Underwriting Risk

- Contractor (Builder)
- Construction Project
- Borrower

+

Completion Risk

- Project Control
- Disbursements
- Statute Compliance

Fraud Risks

- Underwriting the Contractor–Background Check
- No Arms-Length Relationship Between Parties
 - » Borrower
 - » 203(k) Consultant
 - » Contractor
 - » Loan Officer
- Scope Changes



Rehab Contractor Underwriting Risks (Pre-Loan)

- Insufficient Experience
 - » Project Type
 - » References
 - » Previous Sales
- Insufficient Insurance
 - » Commercial General Liability Insurance
 - » Worker's Compensation Insurance
- Not Properly Licensed
- Historical Credit Delinquencies
 - » Credit Score
 - » Public Records: Bankruptcies, Tax Liens, Judgments
- Fraud
- Criminal Background Checks

Underwriting the Rehab Contractor

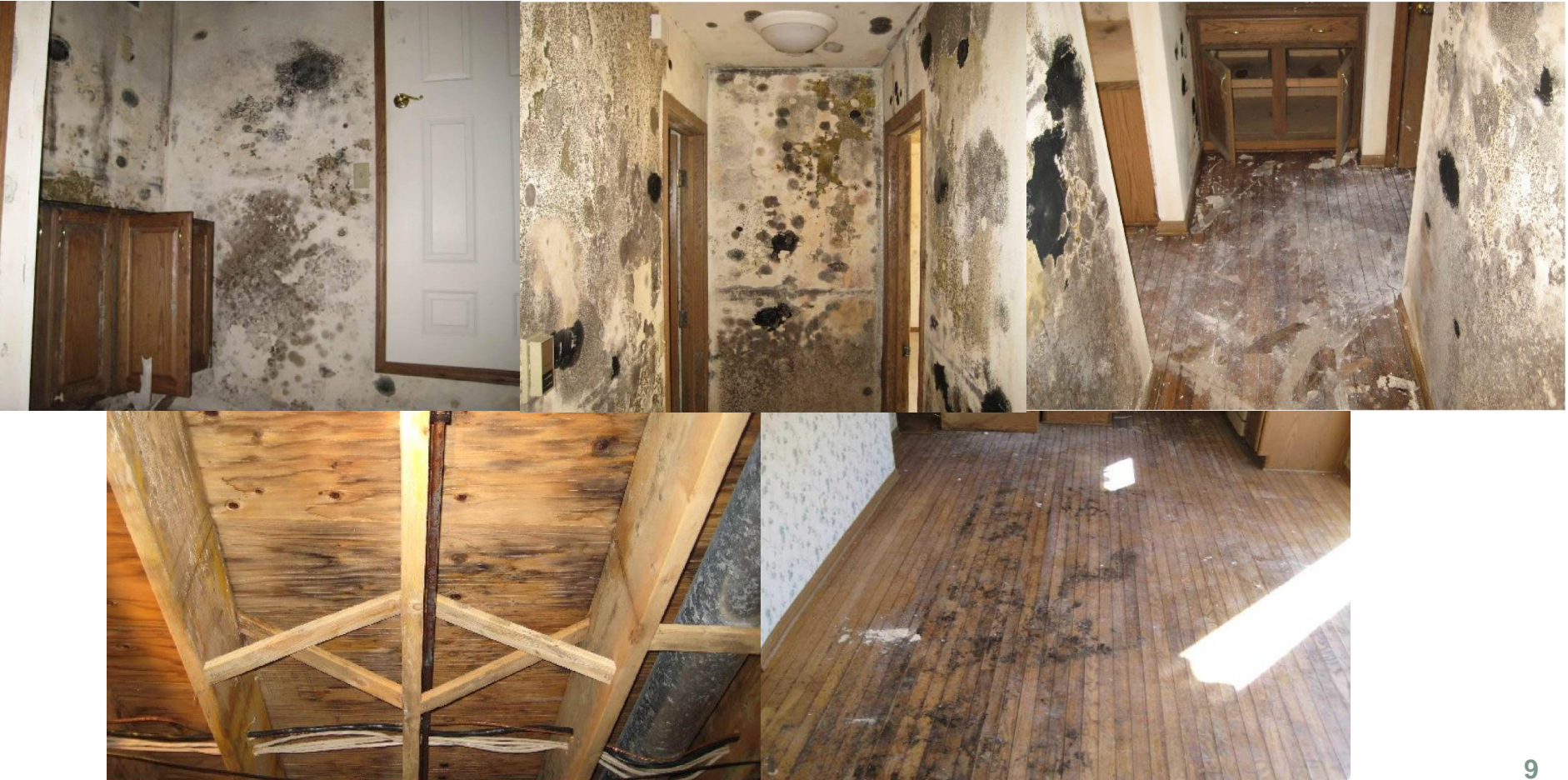
- Large Rehab Project Over \$125K
 - » Former Client References
 - » Subcontractor & Supplier References
 - » Contractor Credit Report
 - » Criminal Background Check
 - » Business Credit Report
- Smaller Rehab Project Under \$125K
 - » Contractor's License & Expiration Tracking
 - » Insurances & Expiration Tracking
 - » Driver's License & W-9



Rehab Project Underwriting Risks (Pre-Loan)

- Insufficient Budget - *#1 reason for a failed construction loan.*
 - » Not Enough Funds to Complete Project
 - » Under-Detailed Budget
- Insufficient Construction Contract
 - » Not Enforceable
 - » Language Conflicts with Lending Guidelines
- Insufficient Plans
 - » Under-Detailed
 - » Incomplete
- Permits
 - » Insufficient Permits
 - » Plans Sign off
 - » Zoning
- Intent of Scope of Work

Rehab Problems: Mold Discovery



Rehab Problems: Change in Scope of Work



Rehab Problems:

Extensive Repairs Required, Insufficient Budget



Setting walls and plumbing

Rehab Problems: Meth House



Project Underwriting Review & Recommendation

- Underwrite the Project
 - ✓ Plans & Specifications
 - ✓ Budget
 - ✓ Contract(s)
 - ✓ Appraisal
 - ✓ Environmental Report(s), if applicable
 - ✓ Soils Report, if applicable
 - ✓ Construction Schedule
 - ✓ Permits
 - ✓ Scope of Work Letter

HUD Consultant Risk

- Underwriting the HUD Consultant
 - » Inexperience
 - » Disinterested Third Party
 - » Lead Source for Loan Officer
 - » Lender Liability - Going Beyond Scope

Pre-Loan Requirements

- Specific State Required Filings
- Permits
 - » Building
 - » Septic/Sewer
 - » Well/Water Specialty
- Insurance
 - » Builder's Risk
 - » Hazard & Flood



Post-Loan Construction Risks

- Statutory Requirements
- Mechanics' Liens
- Inspections
- Change of Scope
- Change Orders
- Project Inactivity
- Variance

Fund Control Procedures

- Large Rehab Project Over \$125K
 - » Permits
 - » Draw Disbursement Authorization
 - » Construction Budget
 - » Draw Support Documentation
 - Invoices
 - Unconditional Release
 - Title Run-Down
 - » Inspection Variances - % Disbursed vs. % Completed
 - » Final Draw Documentation
- Smaller Rehab Project Under \$125K
 - » Joint checks: Contractor/Borrower

Inspection Risks

- Project Scope Changes
- Change Orders
- Diversion of Materials
- Over-Disbursed
- Lender Liability: Do Not Inspect for Quality
- Budget: Front-Load, Under-Detailed

Keys to Success

- Understanding Scope of Work
- Get the Details
- Tools to Monitor Progress
- Proactive, ongoing communication with all parties

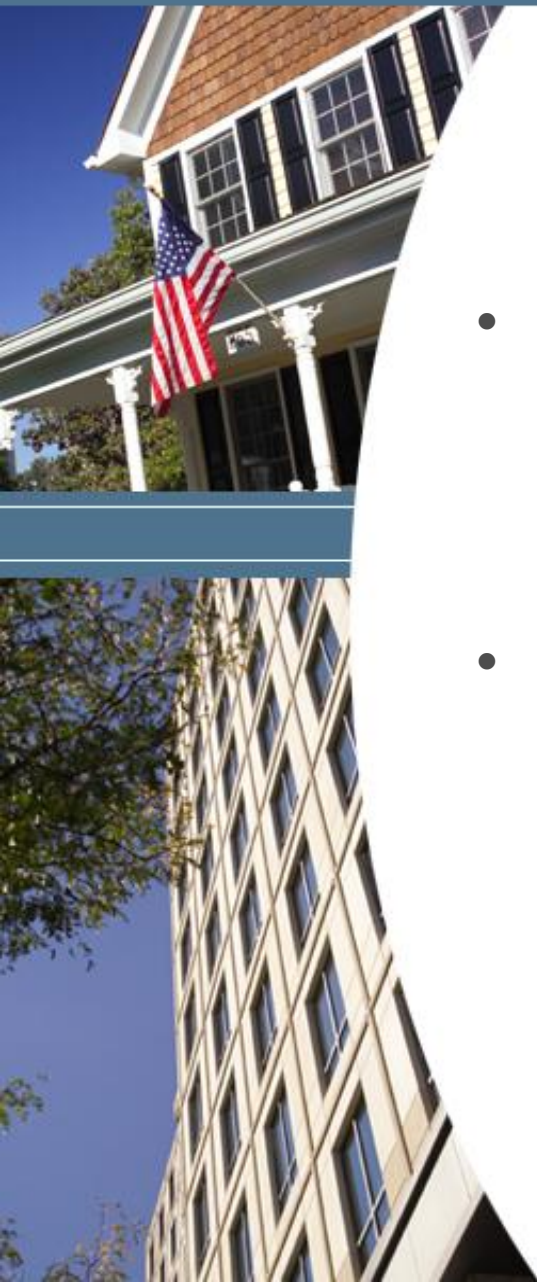
Rehab Summary

Approved for a new kitchen = \$25,000

Inspector Fee = \$150

Finding out there is no house to inspect = Priceless!





For more information on best practices and rehab projects, please contact:

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