DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR-5397-N-03]
RIN 2502-ZA05

Federal Housing Administration (FHA): Temporary Exemption from Compliance with FHA's Regulation on Property Flipping Extension of Exemption

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

ACTION: Notice.

SUMMARY: This notice announces that FHA is extending the availability of the temporary waiver of its regulation that prohibits the use of FHA financing to purchase single family properties that are being resold within 90 days of the previous acquisition, until December 31, 2011. This waiver, which was issued in January 2010, took effect for all sales contracts executed on or after February 1, 2010, and is set to expire on February 1, 2011. Prior to the waiver, a mortgage was not eligible for FHA insurance if the contract of sale for the purchase of the property that is the subject of the mortgage is executed within 90 days of the prior acquisition by the seller and the seller does not come under any of the exemptions to this 90-day period that are specified in the regulation.

As a result of the high foreclosures that have been taking place across the nation, FHA, through the regulatory waiver, encourages investors that specialize in acquiring and renovating properties to renovate foreclosed and abandoned homes with the objective of increasing the availability of affordable homes for first-time and other purchasers and helping to stabilize real estate prices as well as neighborhoods and communities where foreclosure activity has been

high. While the waiver is available for the purpose of stimulating rehabilitation of foreclosed and abandoned homes, the waiver is applicable to all single family properties being resold within the 90-day period after prior acquisition, and was not limited to foreclosed properties. Additionally, the waiver is subject to certain conditions, and eligible mortgages must meet these conditions to take advantage of the waiver. The waiver is not applicable to mortgages insured under HUD's Home Equity Conversion Mortgage (HECM) Program.

On May 21, 2010, HUD published a notice that solicited public comment on the waiver, and specifically the conditions to which the waiver is subject. This notice issued in today's edition of the Federal Register not only announces the extension of HUD's waiver of its property flipping regulations, but also responds to the public comments submitted in response to the May 21, 2010, notice. HUD considered the public comments but makes no changes in response to these comments. The waiver is therefore extended without change. Although no changes are made to the conditions to which the waiver is subject, this notice also includes guidance on the waiver conditions in response to questions that have arisen from time to time during the first year in which the waiver was made available. Additionally, this notice again welcomes public comment on the waiver.

DATES: Effective Date: **February 1, 2011 through December 31, 2011.**

DATES: Comment Due Date. **[Insert date that is 60 days after the date of publication in the Federal Register.]**

ADDRESSES: Interested persons are invited to submit comments regarding this rule to the Regulations Division, Office of General Counsel, 451 7th Street, SW, Room 10276, Department of Housing and Urban Development, Washington, DC 20410-0500. Communications must refer

to the above docket number and title. There are two methods for submitting public comments. All submissions must refer to the above docket number and title.

1. Submission of Comments by Mail. Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW, Room 10276, Washington, DC 20410-0500.

2. Electronic Submission of Comments. Interested persons may submit comments electronically through the Federal eRulemaking Portal at www.regulations.gov. HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the www.regulations.gov website can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

Note: To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the rule.

No Facsimile Comments. Facsimile (FAX) comments are not acceptable.

Public Inspection of Public Comments. All properly submitted comments and communications submitted to HUD will be available for public inspection and copying between 8 a.m. and 5 p.m. weekdays at the above address. Due to security measures at the HUD Headquarters building, an advance appointment to review the public comments must be scheduled by calling the Regulations Division at 202-708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number through TTY by calling

the Federal Information Relay Service at 800-877-8339. Copies of all comments submitted are available for inspection and downloading at www.regulations.gov.

FOR FURTHER INFORMATION CONTACT: Karin B. Hill, Director, Office of Single Family Program Development, Office of Housing, Department of Housing and Urban Development, 451 7th Street, SW, Washington, DC 20410-8000; telephone number 202-708-2121 (this is not a toll-free number). Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Information Relay Service at 800-877-8339.

SUPPLEMENTARY INFORMATION:

I. Background

In this extension of the waiver, HUD repeats the background, as provided in the May 21, 2010 (75 FR 28632), that led to HUD's decision to issue the waiver.

Section 203.37a(b)(2) of HUD's regulations (24 CFR 203.37a(b)(2)) establishes FHA's rule on property flipping and this regulatory section provides that FHA will not insure a mortgage for a single family property if the contract of sale is executed within 90 days of the acquisition of the property by the seller. Section 203.37a(c) lists the sales transactions that are exempt from this rule. The exempt transactions include, for example, sales by HUD of real estate-owned (REO) properties under HUD's regulations in 24 CFR part 291, sales by another federal agency of REO properties, sales of properties by nonprofit organizations that have been approved to purchase and resell HUD REO properties, and sales by state- and federally-charted financial institutions and government sponsored enterprises, to name a few.

Property "flipping" refers to the practice whereby a property recently acquired is resold for a considerable profit with an artificially inflated value, often the result of a lender's collusion

with the appraiser. Most property flipping occurs within a matter of days after acquisition, and usually with only minor cosmetic improvements, if any. In an effort to preclude this predatory lending practice with respect to mortgages insured by FHA, HUD issued a final rule on May 1, 2003 (68 FR 23370) that provides in 24 CFR 203.37a that FHA will not insure a mortgage if the contract of sale for the purchase of the property that is the subject of the mortgage is executed within 90 days of the prior acquisition by the seller and the seller does not come under any of the exemptions to this 90-day period that are specified in § 203.37a(c).

In a final rule published on June 7, 2006 (71 FR 33138), HUD expanded the exceptions contained in § 203.37a(c) to the 90-day time restrictions to include such transactions as sales of single family properties by government-sponsored enterprises (GSEs), state- and federally-chartered financial institutions, nonprofits organizations approved to purchase HUD Real Estate-Owned (REO) single family properties at a discount with resale restrictions, local and state governments and their instrumentalities, and, upon announcement by HUD through issuance of a notice, sales of properties in areas designated by the President as federal disaster areas.

The downturn in the housing market over the past few years has led to a rapid rise of homeowners defaulting on mortgages, and consequently an increase in foreclosed homes. A variety of measures to avoid foreclosures have been initiated at the federal, state and local level, most notably the Administration's Home Affordable Modification Program. Despite these efforts to keep families in their homes, foreclosures continue to remain high and not only do foreclosures affect the families that lost their homes, but they affect neighborhoods and communities. While HUD continues its efforts to help homeowners remain in their homes, through waiver of its regulation on property flipping, HUD seeks to help stabilize neighborhoods and communities.

As noted in its May 21, 2010, notice, HUD undertook similar waiver action in a narrower context in 2009, regarding HUD's Neighborhood Stabilization Program (NSP). NSP, a temporary program authorized by the Housing and Economic Recovery Act 2008 (Public Law 110-289, approved July 30, 2008), was established for the purpose of stabilizing communities that have suffered from foreclosures and abandonment, by allocating funds through a formula to States and units of general local government, for the purchase and redevelopment of foreclosed and abandoned homes and residential properties. HUD's waiver of its regulation on property flipping for NSP removed an impediment to the purchase of affordable homes that had been rehabilitated and sold under this program.

With the home foreclosure rate remaining high across the nation, HUD determined, early in 2010, that a temporary waiver of this regulation on a nationwide basis, subject to certain conditions, may contribute to stabilizing real estate prices and neighborhoods that have been heavily impacted by foreclosures, and may facilitate the sale and occupancy of foreclosed homes that have been rehabilitated by making the mortgages of such homes eligible for FHA mortgage insurance.

During the first year in which the waiver was made available, HUD believes that the waiver has made such a contribution and is therefore extending the waiver until December 31, 2011. As more fully discussed in the appendix to this notice, the waiver has enabled FHA to insure 17,114 mortgages that would not have been eligible otherwise for FHA insurance. In addition, overall HUD real estate owned (REO) purchases and investor purchases have increased by 20 and 25 percent, respectively. For the loans that FHA insured during the first year of the waiver, FHA compared the credit profile of 90-day property flip loans with other loan purchases

(less HECM) to determine if the credit profiles were similar. FHA 90 day property flip loans and other purchase loans are almost identical from a credit perspective.

For 2011, FHA expects its foreclosure inventory to increase by 50 percent. Home prices declined for a third month (including distressed sales) by 3.93 percent in October 2010, compared to a year ago. The distressed sale share remains at 28 percent. The shadow inventory (90+ delinquencies, foreclosures and REOs not listed for sale) is estimated between 2 to 4 million units. As a result, the housing inventory is expected to remain elevated for some time. HUD provides a more detailed discussion of its assessment of granting the waiver in 2010, in the appendix to this notice.

While the waiver remains available for the purpose of stimulating rehabilitation of foreclosed and abandoned homes for another calendar year, the waiver continues to remain applicable to all properties being resold within the 90-day period after prior acquisition. The waiver is not limited to the resale of foreclosed properties.

II. Discussion of the Public Comments Received in Response to the May 21, 2010 Notice

In the May 21, 2010, notice, HUD solicited comments from industry, potential purchasers, and other interested members of the public on the conditions that must be met for the waiver to be provided. The public comment period closed June 21, 2010, and eight public comments were received in response. After careful consideration of the comments, HUD decided to make no changes to the waiver eligibility conditions. For the convenience of the readers, the waiver eligibility conditions are set forth in Section III, followed by guidance on these conditions in Section IV.

The following presents a summary of the significant issues raised by the comments in response to the May 21, 2010, notice, and HUD's responses.

Comment: Support for waiver. The majority of the commenters supported the waiver. These commenters wrote that the anti-flipping regulation delays bringing affordable properties back on the market. Several of the commenters requested that FHA make the exemption permanent for transactions that meet the eligibility criteria specified in the notice.

HUD Response. HUD appreciates the support expressed by these commenters, and agrees that the waiver will help to stabilize neighborhoods and communities. With respect to those commenters advocating that the exemption be made permanent, HUD is not prepared at this time to permanently remove the resale "property flipping" restrictions from its regulation.

Comment: Opposition to waiver. Two commenters expressed the view that the waiver was not in the interest of homebuyers or the American taxpayer. The commenters wrote that the waiver of the property flipping guidelines will hurt homebuyers by permitting investors to purchase and quickly resell properties at inflated value "with little more than fresh paint and a general cleaning."

HUD Response. As noted, HUD will grant waivers only if the mortgagee can meet certain specified conditions designed to address the concerns raised by the commenters. Among other conditions, the mortgagee must demonstrate that that the purchase transaction is arms-length in nature, that the property has not been the subject of prior "flipping," and that the property was fairly and openly marketed for sale. Further, the mortgagee must justify and document any sales price that exceeds the seller's acquisition costs by 20 percent or more.

Comment: Clarify seller acquisition cost. Several commenters urged that HUD clarify that the seller's acquisition cost excludes any costs of rehabilitation. The commenters wrote that

the 20 percent limit does not account for the high cost of the extensive repairs frequently needed to place abandoned or foreclosed properties on the market.

HUD Response. The waiver eligibility conditions sufficiently address the concerns raised by the commenters. Specifically, the eligibility conditions do not prohibit resales that exceed 20 percent of the seller's acquisition costs but, rather, simply require the mortgagee to justify and document the reasons for the increase in value. As noted above, such reasons may include the completion of sufficient legitimate renovation, repair, and rehabilitation work.

III. Eligibility for Waiver of 24 CFR 203.37a(b)(2)

To be eligible for the waiver of the Property Flipping Rule, an FHA-approved mortgagee must meet the following conditions:

1. All transactions must be arms-length, with no identity of interest between the buyer and seller or other parties participating in the sales transaction. Some ways that the lender can ensure that there is no inappropriate collusion or agreement between parties, are to assess and determine the following:

a. The seller holds title to the property;

b. Limited liability companies, corporations, or trusts that are serving as sellers were established and are operated in accordance with applicable state and federal law;

c. No pattern of previous flipping activity exists for the subject property as evidenced by multiple title transfers within a 12 month time frame (chain of title information for the subject property can be found in the appraisal report);

d. The property was marketed openly and fairly, through a multiple listing service (MLS), auction, for sale by owner offering, or developer marketing (any sales contracts that refer to an

"assignment of contract of sale," which represents a special arrangement between seller and buyer may be a red flag).

2. In cases in which the sales of the property is greater than 20 percent above the seller's acquisition cost, an FHA-approved mortgagee is eligible for the waiver only if the mortgagee:

a. Justifies the increase in value by retaining in the loan file supporting documentation and/or a second appraisal, which verifies that the seller has completed sufficient legitimate renovation, repair, and rehabilitation work on the subject property to substantiate the increase in value or, in cases where no such work is performed, the appraiser provides appropriate explanation of the increase in property value since the prior title transfer; and

b. Orders a property inspection and provides the inspection report to the purchaser before closing. The mortgagee may charge the borrower for this inspection. The use of FHA-approved inspectors or 203(k) consultants is not required. The inspector must have no interest in the property or relationship with the seller, and must not receive compensation for the inspection for any party other than the mortgagee. Additionally, the inspector may not: compensate anyone for the referral of the inspection; receive any compensation for referring or recommending contractors to perform any repairs recommended by the inspection; or be involved with performing any repairs recommended by the inspection. At a minimum, the inspection must include:

i. The property structure, including the foundation, floor, ceiling, walls and roof;

ii. The exterior, including siding, doors, windows, appurtenant structures such as decks and balconies, walkways and driveways;

iii. The roofing, plumbing systems, electrical systems, heating and air conditioning systems;

iv. All interiors; and

v. All insulation and ventilation systems, as well as fireplaces and solid fuel-burning appliances.

3. Only forward mortgages are eligible for the waiver. Mortgages insured under HUD's HECM program are ineligible for the waiver.

IV. Guidance on the Conditions for Waiver Eligibility

A. Seller's Acquisition Cost

The seller's acquisition cost is the purchase price which the seller paid for the property, and the following costs (if paid by the seller):

- Closing costs, plus
- Prepaid costs, including commissions.

The seller's acquisition cost does not include the cost of repairs that the seller makes to the property.

B. Justification and Documentation of Increase in Value

If the resale price of the property is greater than 20 percent above the seller's acquisition cost, the property will be eligible for an FHA-insured mortgage only if the Mortgagee justifies the increase in value. The Mortgagee must verify that the seller has completed sufficient legitimate renovation, repair, or rehabilitation work on the subject property to substantiate the increase in value by retaining supporting documentation in the loan file or by providing a second appraisal.

- If the Mortgagee uses a second appraisal:
    - An FHA roster appraiser must perform the appraisal in compliance with all FHA appraisal reporting requirements.

- The Mortgagee may not use an appraisal done for a conventional loan even if it was completed by an FHA roster appraiser.
- The Mortgagee may not charge the cost of the second appraisal to the homebuyer.

If the Mortgagee has ordered a second appraisal to document the increase in value, the Mortgagee must not use this appraisal for case processing and must not enter it into FHA Connection.

C. Property Inspection Report

If the resale price of the property is greater than 20 percent above the seller's acquisition cost, the property will be eligible for an FHA-insured mortgage only if the Mortgagee obtains a property inspection and provides the inspection report to the buyer before closing. The borrower, lender, or mortgage broker (if one is involved in the transaction) may order the property inspection. The lender or mortgage broker may charge the borrower for this inspection.

D. Repairs

If the inspection report notes that repairs are required because of structural or "health and safety" issues, those repairs must be completed prior to closing. After completion of repairs to address structural or "health and safety" issues, the inspector must conduct a final inspection to determine if the repairs have been completed satisfactorily and eliminated the structural or "health and safety" issues. The borrower, lender, or mortgage broker may order the final inspection.

V. Compliance with the Paperwork Reduction Act

The information collection requirements applicable to this waiver have been submitted to the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44

U.S.C. 3501-3520) and assigned OMB Control No. 2502-0059. In accordance with the Paperwork Reduction Act, an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless the collection displays a currently valid OMB control number.

VI. Period of Waiver Eligibility

The waiver that is the subject of this notice remains effective beyond February 1, 2011, through December 31, 2011, for all sales contracts executed on or after February 1, 2010, the eligibility date provided by the issuance of the waiver in January 2010, unless extended or withdrawn by HUD.

By notice, HUD shall notify the public of any extension or withdrawal of this waiver. If as a result of this waiver, there is a significant increase in defaults on FHA-insured mortgages and an increase in mortgage insurance claims that are attributable to mortgages insured as a result of exercise of this waiver authority, HUD may withdraw this waiver immediately.

VII. Solicitation of Public Comments

HUD again welcomes comments on the conditions specified in this notice for eligibility for waiver of its regulation on property flipping.

Dated: January 28, 2011

David H. Stevens
Assistant Secretary for Housing—
Federal Housing Commissioner

[FR-5397-N-03]

Appendix

Assessment of Exemption from Compliance with FHA's Regulation on Property Flipping in Calendar Year 2010

On February 1, 2010, FHA issued a one year waiver of regulation 24 CFR 203.37a(b)(2) that prohibits the use of FHA financing to purchase properties that are being resold within 90 days of the prior acquisition by the seller. At the time the waiver was issued, the housing market was still experiencing high rates of foreclosure which had started over the previous two year period and was expected to continue until market conditions improved. The housing market continues to experience high rates of foreclosures, and as of October, 2010, the housing supply for existing homes is at 10.5 months. In addition, FHA expects its foreclosure inventory to increase by 50 percent in 2011. Home prices declined for a third month (including distressed sales) by 3.93 percent in October 2010, compared to a year ago. The distressed sale share remains at 28 percent. The shadow inventory (90+ delinquencies, foreclosures and REOs not listed for sale) is estimated between 2 to 4 million units. As a result, the housing inventory is expected to remain elevated for some time. Investors and homeowners are finding value in purchasing REOs in the current market. Investors are more likely (52 percent) to purchase damaged properties versus first-time or current homeowners (Inside Mortgage Finance, June 2010). Since the waiver went into effect, overall HUD real-estate owned (REO) purchases and investor purchases have increased by 20 and 25 percent, respectively.

The waiver implemented various controls to help mitigate the risks associated with 90 day property flips. The transaction has to be arms-length with no pattern of previous flipping. If the sale of the property is 20 percent above the seller's acquisition cost, the increase in value must be justified with:

- A 2nd appraisal ***and/or*** supporting documentation justifying the increase in value

-AND-

- Property inspection report to be ordered by the Lender.

In addition, if the sale of the property is 20 percent above the seller's acquisition cost, the loan was targeted for a Post Endorsement Technical Review (PETR). To ensure FHA's risk controls are adequate, FHA analyzed and compared 90 day property flipping loan data and other purchase loan data in three key areas: 1) EPDs; 2) Credit Profile; and 3) Property Defects.

1. Early Payment Defaults (EPDs) are defined as a 90-day delinquency within the first 6 payment cycles. There are currently 5 EPD loans for 90-day property flip loans. Below is a comparison of FHA 90-day flip loans to other purchase mortgages (less HECM) endorsed between 2/1/10 and 10/31/10. It should be noted that it is too early to draw any meaningful conclusions concerning EPDs since the waiver was implemented in 2/1/10.

	Flips	**Purchases**
Loans	17,114	1,200,650
EPDs	5	1,742
Percentage	0.03%	0.15%

2. FHA insured 16,999 loans under this waiver from 2/1/10 through 9/31/10. FHA compared the credit profile of 90-day property flip loans with other loan purchases (less HECM) to determine if the credit profiles were similar. FHA 90 day property flip loans and other purchase loans are almost identical from a credit perspective.

Loan Type	**Average Front End Ratio**	**Average Back End Ratio**	**Average Total Score**
90 day Property Flip	27.92	40.86	694

Other Purchases	26.96	40.58	698

3. Of the 16,999 loans, FHA reviewed 833 (4.9 percent) 90-day property flip loans through its Post Endorsement Technical Review (PETR) process from 2/1/10 through 9/31/10. FHA compared the percentage of loans rated Unacceptable for Valuation Review to PETR Reviews and to the 90-day property flip loan population. Currently, 90 day property flip loans have substantially more Unacceptable Valuation ratings compared to other purchase loans (less HECM). The percentage of unacceptable valuation reviews to PETR reviews for 90-day property flipping loans is 47.54 percent. However, the majority of these Unacceptable Valuation reviews are the result of documentation compliance issues (i.e. missing inspection report, 2nd Appraisal, Termite Report). It should be noted that these are new requirements for the mortgagee and FHA. The mortgagees were interpreting the controls inconsistently/incorrectly. In addition, these loans were originated this year and the process of resolving documentation issues can often take several months. Actual property defects (issues with the actual property such as holes in the walls, faulty wiring, etc.) are limited to 10.08 percent which is comparable to FHA's other purchase loans. .

Loan Type	**Percentage of Unacceptable Valuation Reviews to PETR Reviews**	**Percentage of Unacceptable Valuation Reviews to loan population**
90 day Property Flip	10.08% (Property Defects)	.49%
Other Purchases	9.79%	.39%