# Committee on Healthcare Financing



1850 M Street N.W.
Suite 400
Washington D.C. 20036

September 22, 2014

Mr. Roger Miller
Deputy Assistant Secretary
Office of Healthcare Programs
Department of Housing and Urban Development
451 7th Street SW, Room 6264
Washington, DC 20410

Mr. Roger Lewis
Director, Office of Residential Care Facilities
Department of Housing and Urban Development
909 First Avenue, Suite 260
Seattle, WA 98104-1000

RE: Handbook 4232.1
Section 232 Mortgage Insurance Program

Dear Mr. Miller and Mr. Lewis:

We are writing on behalf of the Committee on Healthcare Financing[1], to provide comments on the Department of Housing and Urban Development's ("**HUD**") new Section 232 handbook (Handbook 4232.1), which was published on May 22, 2014 (the "**New Handbook**"). First of all, we applaud the tremendous effort by HUD's Office of Residential Care Facilities ("**ORCF**") in writing a Section 232 specific handbook from the countless LEAN blasts, Mortgagee Letters, prior handbooks, and other guidance. Overall, we believe the ORCF did an excellent job putting together the New Handbook.

Over the past few months, we've worked with members of the Committee to review the New Handbook in order to determine if any changes or clarifications are needed. Our understanding is that HUD's intentions with respect to the New Handbook were to organize and clarify existing Section 232 underwriting and program guidelines, not create new policies. In that regard, we believe that ORCF has generally accomplished that task; however, we have identified a few areas that we believe need either adjustment or further clarification, as they may be interpreted as policy changes. Therefore, we present the following comments for your consideration. As always, we are happy to discuss these directly with you and your team.

[1] The Committee on Healthcare Financing is an association of national investment and mortgage bankers and financial advisors who participate in the Department's Sections 232 and 242 mortgage insurance programs.

## A. SECTION I – HANDBOOK INTRODUCTION

1. **<u>Chapter 2.5.C</u>** – This section prohibits "[a]ny identity of interest between a consultant (as defined herein) and the Section 232 Lender or any affiliated entity." A consultant is a "loan correspondent," "broker," or "packager," and those entities are typically paid by the Lender or from the financing fee of the mortgage loan. However, HUD has defined "identity of interest" ("**IOI**") to mean "any relationship based on family ties or *financial interests* between or among two or more entities involved in a project-related transaction which reasonably gives rise to a presumption that the entities may not operate at arms-length."[2] We ask that HUD provide a definition or more clarity on the type of "financial interest" that gives rise to an IOI. We do not believe it is HUD's intent to prohibit a lender from paying a consultant a fee for the consultant's work; however, we do believe it would be helpful in future interpretations of the New Handbook that it is clear such arrangements are not deemed a prohibited IOI.

   An additional concern with this prohibition is that many lenders have affiliates or other corporate divisions that will be prohibited from working with the FHA lender team on a common project. We think it would be better for the program if an FHA lender is able to work with others it its company's organization to develop projects for Section 232 financing without violating IOI rules.

2. **<u>Chapter 2.13.C.</u>** – This section presents a potential, and very troubling, consequence. Pursuant to this provision, HUD has prohibited "Lender collusion with or influence upon third party contractors to modify reports prepared by the contractor that affect the contractor's independent evaluation." It is typical, and required by HUD, for lenders to review third-party reports and make corrections. In fact, the process of getting the report in final shape is a collaborative process and ultimately may involve HUD or the lender requiring changes. Moreover, there are times when a contractor's assumptions may be incorrect, leading to conclusions that are changed based on the lender's discussions with the third-party contractor (or with HUD and then relayed to the third party contractor). Chapter 2.13.C. could then turn very normal lender/third-party contractor dialogue into impermissible collusion. We believe HUD wants the lenders to review third party reports and correct any errors or misstatements contained therein. Therefore, we ask that this section be modified to read the following:

   > "Lender collusion with or influence upon third party contractors to modify reports prepared by the contractor that cause the contractor's report to misrepresent a material fact to HUD, cause the HUD loan amount to be improperly increased, or otherwise be misleading or inaccurate."

## B. SECTION II – PRODUCTION

3. **<u>Chapter 2.5.FF.2.c</u>** – This section indicates that <u>publicly traded</u> companies must obtain 2530 clearance for "all stockholders that own 10% or more of the company's stock." However, the HUD Form 2530 requires clearance for "all stockholders that own 10% or more of the company's stock" for both publically <u>and</u> privately traded corporations. Should this section include "privately" held corporations as well?

[2] *See* Section 232 Handbook, Section I, Chapter 1.6.A. (emphasis added).

4. **Chapter 2.8.E.** – The ORCF has limited a Section 241 loan to the "term of the existing insured mortgage." Attached to this letter is a letter from Philip Abrams, General Deputy Assistant Secretary dated May 4, 1982, wherein Mr. Abrams states that HUD permits a Section 241 loan term to exceed the term of an existing HUD-insured mortgage. Therefore, we ask that ORCF amend this section to allow a Section 241 loan term to exceed the remaining term on the first HUD-insured loan, consistent with prior HUD guidance.

5. **Chapter 2.10.L.2.** – We believe that the requirement of escrowing 120% of the non-critical repair cost should be changed to "110%" for Section 232/223(a)(7) loans. Doing so will make this section consistent with the New Handbook's Section II, Chapter 9.6.5., and prior HUD policy.

6. **Chapter 2.11.B.** – To satisfy National Housing Act Section 223(d) requirements, we suggest adding the following additional requirement:

   "9. The original mortgage and the operating loss loan must be cross-defaulted."

7. **Chapter 3.3.B.1**- This section indicates that the "purchase price" of the site is eligible to be included in the insured loan for new construction, sub-rehab, blended rate, and supplemental loan projects. However, the "market value" of the site, rather than the purchase price, has typically been mortgage eligible. We understand that the project's replacement cost has always included the market value of the site or "as-is" value of the building in sub-rehab cases. We ask that HUD clarify this section because limiting the mortgageable cost to just the purchase price would be a change in HUD policy.

8. **Chapter 3.13.E.2** - In this section, the ORCF has laid out criteria that must be met in order for a sale-lease back transaction to not be considered an IOI. Even if those conditions are met, the transaction is still an IOI transaction, it's just not a prohibited IOI transaction. We ask that ORCF make those same considerations apply to Chapter 3.13.E.1. In other words, if the criteria laid out in 3.13.E.2 are met, then a transaction where there is an IOI between the seller and a purchaser that survives the purchase can still be permitted to close as an acquisition rather than be seasoned. If the conditions in 3.13.E.2 apply to 3.13.E.1, then we do not see the need for a two year seasoning period.

9. **Chapter 3.13.F** - For clarity purposes, we ask that HUD include a statement to the effect of "merely requiring a Debt Investigation does not mean that the Debt is per se ineligible."

10. **Chapter 3.13.G** - When describing "Eligible Debt," HUD allows borrowers to include in the refinance amount the items listed under Chapter 3.13.A and B. We ask that HUD expand the referenced section to include purchase scenarios. To accomplish this, we would ask HUD to amend the New Guide Section II, Chapter 3.13.G.1 as follows: [3]

    "A bridge loan is a loan that is short term in nature that allows a Borrower to borrow short term funds to bridge a gap between the repayment of the previous loan or financing structure (or a purchase) and permanent financing such as an FHA-insured loan. Bridge loans are subject to debt seasoning, identity of interest lenders and review of recent indebtedness requirements as outlined in Section 3.13 A, Section 3.13 B, Section 3.13 C,

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[3] Changes to HUD text are underlined.

Section 3.13 D, and Section 3.13 E. The bridge loan itself does not need to season for two years if the amount of the bridge loan is equal to the outstanding principal amount of the previous loan, <u>or the purchase price, the uses of the bridge loan are eligible uses as previously</u> defined, and there was no equity cash out to any individual or entity. A Debt Investigation would only be required when the total timeframe of the two previous loans, the outstanding project loan and the short term bridge loan, is less than 24 months."

11. **<u>Chapter 3.15.C.</u>**- Repayment of Secondary Financing

(a) The New Handbook limits the repayment of public or private secondary financing to 75% of "available surplus cash or residual receipts." Prior HUD policy placed a 50% limit on distributions of surplus cash only when the secondary financing was secured by a second mortgage. There were no limitations on surplus cash distributions used to repay secondary debt when no mortgage was placed on the project. We understand that there have been a number of secondary financings completed where there is no 75% of surplus cash limitation in effect because of the fact that the surplus cash note was <u>not</u> secured by a mortgage. Because the New Handbook is part of HUD's catch-all "Program Obligations," we are concerned that deals that have closed prior to the New Handbook may retroactively be subject to this stricter distribution requirement.

(b) Another concern with this section is that it provides Borrowers the option to make additional payments towards the secondary financing from non-project funds that are not pledged or scheduled for repayment. Because the Borrower has to be a sole-purpose entity, will HUD please indicate the type of non-project funds that may be used for such option? Would this include related party management fees?

12. **<u>Chapter 4.1.C.</u>** – Architectural Standards and Other Criteria

(a) **<u>Chapter 4.1.C.3</u> -** We have discussed the seismic requirements with certain industry experts and understand that the New Handbook has retained outdated references to FEMA handbooks. It has been explained to us that newer standards have been developed and published by the American Society of Civil Engineers, so that retaining the references to FEMA handbooks may create confusion. The HUD Housing team has updated their seismic requirements and those can be found in the *CAN e-tool Guidance* under the *Property--Enter Property Info* tab. The housing guidance references the more updated ASCE handbooks. We request that the ORCF reach out to both the HUD housing team and industry seismic experts to update Chapter 4.1.C.3 to reference the current and appropriate industry standards. We are happy to work with the ORCF to coordinate any discussions with industry experts.

(b) Please clarify that Section II, Chapter 4.1.C.5 applies to Skilled Nursing Facilities only.

(c) In Section 4.1.C.6.d, please indicate which edition of the International Building Code controls for HUD projects.

13. **<u>Chapter 4.3.A.1</u> -** There appears to be a conflict between Chapter 2.6.B.1 and Chapter 4.3.A.1 (both in Section II of the New Handbook). In the former, major moveable equipment is <u>not</u> included in the hard costs when determining if the project qualifies as a substantial rehabilitation. Chapter 4.3.A.1 includes major moveable equipment in making that same interpretation. Based on comments at the LEAN training in June 2014, we believe Chapter 2.6.B.1 is correct and Chapter 4.3.A.1 should be amended to <u>exclude</u> major moveable equipment.

14. **<u>Chapter 5.4.G</u>** – In order to avoid confusion on how to properly reflect the ground lease expense in the loan sizing, we suggest that the ORCF add to this section an explanation of how to address ground lease rent and expenses in the Maximum Insurance Loan Calculation (MILC). Otherwise, we are concerned that the instruction contained in Chapter 5.4.G will be seen as an additional deduction of costs to be shown in the MILC.

15. **<u>Chapter 7.5 – Environmental Information for the Lender</u>**

    (a) **<u>Chapter 7.5.C</u>** – Surveys and Phase I reports use the FEMA Flood Zone designations with regard to floodplains (e.g., Zone C, X (unshaded), A). To avoid confusion and for ease of identifying floodplain issues, we request that the New Handbook be amended to use the FEMA flood zones in addition to or in place of the traditional 100 or 500 year floodplains.

    (b) **<u>Chapter 7.5.K</u>** – In the introduction to Chapter 7.5, on page 22, the ORCF requires that "additional hazards and nuisances" must be discussed in the project narrative. The examples of such "additional hazards and nuisances" provided in the New Handbook includes "radon, pipelines, vibrations, and fall hazards." However, in Chapter 7.5.K, where "additional hazards and nuisances" are discussed, the New Handbook does not provide guidance on radon, pipelines, vibrations, or fall hazards. We ask that the ORCF provide guidance on those matters so that the project narratives can address them correctly.

    (c) **<u>Chapter 7.5.K.5</u>** - This requires that owners purchase a "special zoning rider in their insurance coverage" if the property is a legal non-conforming use that cannot be rebuilt to current densities. Additionally, HUD requires that this rider "appear in the pro forma title policy." We believe the actual coverage HUD seeks is law & ordinance coverage in the owner's property insurance. Also, this coverage is not a rider to the <u>title</u> insurance policy. Therefore, we ask that HUD update this provision to reflect the appropriate "property" (rather than title) insurance coverage.

16. **<u>Chapter 8.8.G.</u>** – When reading this provision, we are confused if the New Handbook is requiring a review of professional liability insurance for skilled nursing homes only. Or, does this entire provision apply to skilled nursing homes only? If it is ORCF intent to have a review of state surveys and professional liability insurance for other types of facilities, e.g., ALF, then we suggest deleting the phrase "(for Skilled Nursing Facilities)."

17. **<u>Chapter 10.16.A</u>** - Please indicate whether handicapped accessibility deficiencies should be classified as critical or non-critical repairs.

18. **<u>Chapter 14.1.D</u>** – The New Handbook prohibits borrowers from financing insurance policy premiums. Many borrowers pay their policies on a monthly basis and the insurance companies charge fees for that option. In essence that is a cost to finance because the fee would not be charged if the entire premium were paid up front. Therefore, we would propose modifying this provision to prohibit the financing of premiums by third-party lenders, but allow it if done by the insurance company pursuant to a normal payment plan.

19. **<u>Chapter 17.7.H</u>** – The New Handbook requires the lender to make certain certifications regarding factual matters of the borrower, operator, etc. First, we ask that HUD clarify that any lender certification pursuant to this provision can be done "to the best of lender's knowledge." Because these are factual matters, the borrower, operator, or those entities/people on the

borrower/operator side are best suited to make such representation. The Lender will be limited in its ability to gain actual knowledge of every matter affecting the borrower. So, we also suggest that HUD require this certification from the Borrower and Operator.

## C. SECTION III – ASSET MANAGEMENT

20. **<u>Chapter 3.2.2</u>** – In discussions with our members, we understand there are some common situations regarding releases from the Reserve for Replacement ("**R4R**") fund on which we would ask HUD to provide more guidance. When a borrower requests a release from the R4R, the following three instances have created problems for loan servicers to evaluate:

    (a) the repair item is needed, but not listed in the PCNA;
    (b) the repair item costs more than estimated in the PCNA; and
    (c) the repair item needs to be replaced before the end of its useful life as estimated in the PCNA.

    The PCNA provides an analysis of the condition of a building at a set point in time and projects the future capital needs over a fifteen-year period; however, that is still a projection. There should be some flexibility to allow future disbursements from the R4R for conditions that do not exactly reflect the conditions identified in the PCNA. We ask that HUD work with the loan servicing community to develop more clear guidelines for those situations so that servicers will better be able to exercise discretion with disbursements from the R4R.

21. **<u>Chapter 3.2.2.A.2.</u>** – We request that HUD state that mortgagors may invest restricted escrows in qualified investments (i.e. U.S. Treasury Securities, insured certificate of deposits, money market accounts, etc.). This would conform to multifamily guidance wherein a borrower may invest in qualified investments provided such investments are held solely by the lender/servicer. Also, we request that HUD amend this section to provide that a lender/servicer may assess fees and out-of-pocket costs to the borrower for such services.

22. **<u>Chapter 3.2.2.H.</u>** – We understand that the three bid requirement most likely emanates from the HUD construction loan programs and the bidding requirements therein. However, in cases when a borrower/operator is managing its property well, and has expertise on how best to maintain/repair its property, we ask that HUD remove the three bid requirement for non-IOI repair contracts.

23. **<u>Chapter 3.2.4</u>** – When servicing the non-critical repair item, the loan servicers incur costs associated with inspections and obtaining title date down endorsements. We ask that HUD permit lenders, at their discretion, to add those cost estimates in the non-critical repair costs so that the lenders can be reimbursed for those costs.

24. **<u>Chapter 3.2.5.</u>** – We understand that in some situations releases of sinking funds are controlled by a State's Department of Health or other non-HUD governmental entity. In those situations, we ask that HUD clarify that the lenders are not responsible for delivering to HUD the sinking fund deposits in the case of a default and loan assignment. If the lender is unable to disburse funds without the approval of another non-HUD party, then the lender should not be held responsible for delivering those funds to HUD during the insurance claim process if such third party does not provide its consent.

25. **Chapter 3.3.3.B** – The New Handbook requires the approval of the "Deputy Assistant Secretary for ORCF" to override lock-out/prepayment restrictions contained in the FHA-insured note. We believe this action should require the approval of the Deputy Assistant Secretary for the Office of Healthcare Programs.

26. **Chapter 3.4.2** – We request that the ORCF issue a checklist that details those items HUD requires when processing a request to increase or decrease collateral, i.e. beds or real estate.

27. **Chapter 3.8** – Please post the telecommunications towers checklist on the Section 232 website.

28. **Chapters 7 & 8** – Because of the work entailed in the lender's review of a TPA or change in Operator/Manager request, we feel that it is appropriate that lenders charge borrowers a review fee (including any outside counsel fees). Therefore, we ask that the New Handbook indicate that such fees may be charged.

29. **Chapter 9** – We believe that having a checklist that lenders may use when processing requests to release projects from a master lease will be helpful. We would be happy to work with the ORCF to develop such a list.

We thank you for your consideration of these comments and look forward, as always, to working with you and your team to improve the Section 232 program. Please do not hesitate to call us with any questions or comments.

Very truly yours,

Roderick D. Owens

Roderick D. Owens
Executive Director

Enclosure

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING – FEDERAL HOUSING COMMISSIONER

IN REPLY REFER TO:

MAY 4 - 1982

Mr. Donald F. Libretta
Krooth & Altman
2101 L Street, N.W.
Washington, DC 20037

Dear Mr. Libretta:

Please accept our apologies on behalf of former Assistant Secretary Winn for the lateness of our response to your letter of December 7, 1981 in which you request a clarification of the Department's present policy with regard to the maximum term of a supplemental loan insured pursuant to Section 241 of the National Housing Act. This policy has been under consideration for some time.

As you point out, a rule appearing in the Federal Register on October 20, 1981 provides that, "The loan shall have a maturity satisfactory to the Commissioner," in effect, permitting the mortgage term on Section 241 mortgage loans to exceed the term of the existing first mortgage.

Instructions are being prepared for dissemination to HUD field offices which provide that the term of a Section 241 mortgage, where the first mortgage is insured under one of our various programs, may exceed the term of the existing first mortgage. These Section 241 mortgage terms will be limited to the lesser of:

1. three-fourths of the remaining economic life of the structure; or

2. five years less than the maximum term available for a first mortgage under the appropriate program.

I believe that these recent policy determinations address the concerns expressed in your letter.

Your interest in the Department's hospital and nursing home mortgage insurance programs is appreciated.

Sincerely,

Philip Abrams
General Deputy
Assistant Secretary