COMMITTEE ON
HEALTHCARE FINANCING

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

July 2, 2012

Regulations Division, Office of the General Counsel
Department of Housing and Urban Development
451 Seventh Street, S.W., Room 10276
Washington, D.C. 20410

RE: Federal Register Vol. 77, No. 86 published May 3, 2012
Docket No. FR-5465 P-01 – Federal Housing Administration (FHA): Section 232 Healthcare Facility Insurance Program- Strengthening Accountability and Regulatory Revisions Update (the "**Proposed Regulations**")

To Whom It May Concern:

We are writing on behalf of the **Committee on Healthcare Financing**[1] and the **Mortgage Bankers Association**, along with a coalition of national senior residential and healthcare associations that includes the **American Health Care Association, American Seniors Housing Association, Assisted Living Federation of America**, **LeadingAge,** and **National Center for Assisted Living** (the "**Coalition**"), to provide comments to the Department of Housing and Urban Development's (the "**Department**" or "**HUD**") on its proposed changes to the Section 232 regulations published in the Proposed Regulations. First of all, we applaud the Department's efforts over the past several years to update the Section 232 mortgage insurance program by creating the Office of Healthcare Programs and implementing the LEAN processing and underwriting protocols. We understand that the Proposed Regulations, as well as a related notice (i.e. Docket No. FR-5623-N-01) that published for comment many of the Section 232 underwriting and loan closing documents (the "**Proposed Loan Documents**"), represents additional efforts by HUD to further update the Section 232 program.

I. General Comments

The Coalition supports HUD's efforts at continuous improvement of the Section 232 program. In fact, we believe that HUD's programmatic changes over the past few years under the LEAN program have made substantial improvements to the quality and diversity of the Section 232 portfolio. Because of many of those initiatives, which we will discuss below, HUD has become an attractive option to many credit-worthy borrowers and operators, who no longer

[1] Please know that 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. The Mortgage Bankers Association is a trade association representing originators and servicers of loans insured under the Section 232 program. Other Coalition participants are major national trade associations representing non-profit and proprietary sponsors of senior housing and healthcare services, who are also active in HUD Healthcare Programs.

view HUD the lender of last resort. We do, however, have serious concerns about several of the new requirements that would be imposed if the Proposed Regulations and the Proposed Loan Documents were implemented. Our main concern is that many of the changes will discourage the more experienced and sophisticated borrowers and operators, i.e. the better credits, from considering the Section 232 program. HUD and its stakeholders have made tremendous strides over the past few years to change HUD from the "lender of last resort," as it was before LEAN, to a viable, competitive, and attractive financing option. We believe that attracting better credits has done more to reduce risk to the GI/SRI than almost any other single risk mitigation tool undertaken by HUD with regard to the Section 232 program.

First and foremost, we believe that HUD has published an incomplete package of Section 232 requirements by not publishing a draft handbook along with the Proposed Regulations and Proposed Loan Documents.[2] In fact, since HUD's publishing of the updated Multifamily Accelerated Program Guide last summer that removed the Section 232 program provisions from that handbook, the Section 232 program has been under a superseded handbook and various email notices. Without a draft Section 232 handbook, it is impossible for the Section 232 stakeholders to fully review, understand, and comment upon the Proposed Regulations or the Proposed Loan Documents. Many of the proposed changes are vague or subject to varied interpretation, which will lead to delays in underwriting and processing as HUD's lenders and borrowers seek clarification from HUD.[3] Therefore, by not publishing a draft Section 232 handbook along with the Proposed Regulations and the Proposed Loan Documents, HUD is not allowing the public to fully review major changes to the Section 232 program and thus HUD is prohibiting the public from providing comprehensive comments to the Section 232 program.

<u>Therefore we request that HUD, prior to final implementation of the Proposed Regulations and the Proposed Loan Documents, re-publish for comment the Proposed Regulations and the Proposed Loan Documents along with a proposed Section 232 handbook</u>.

A second major area of concern is HUD's great expansion of restrictions placed on borrowers and operators in the Section 232 program without offering a convincing rationale that these new restrictions will provide any better protections to the GI/SRI Fund or enhance the quality of borrowers and/or operators participating in the program. We were greatly concerned with the comment made in the background to the Proposed Rule that stated "Since the operator may not be known to FHA at the time of underwriting, or may change during the term of the mortgage, the risk of operator deficiency is difficult to assess." This comment is inaccurate and inconsistent with underwriting since LEAN was implemented. Under LEAN, Operator

---

[2] At the May 31, 2012, HUD forum on the Proposed Regulations, HUD indicated that HUD was legally required to publish the Proposed Regulations and Proposed Loan Documents prior to implementing a new handbook. We know of no legal requirement that mandates that sequence. In fact, HUD has issued the MAP Guide and updated it several times prior to issuing new multifamily loan documents. Therefore, we believe HUD has the legal authority to issue a draft handbook prior to final publication of the Proposed Regulations and Proposed Loan Documents.

[3] This would take us back to the pre-LEAN days when simple questions would take weeks to be answered because field counsel or program staff did not have the necessary tools or information, thus being forced to seek guidance from Headquarters.

underwriting became the primary focus of lender and HUD analysis. We are concerned that this erroneous view of HUD's actual process may have guided some of the requirements of the new rule.

As stated above, the LEAN program provided HUD with the flexibility to adapt HUD's processes and requirements as HUD deemed necessary and appropriate to strengthen the program's underwriting and closing requirements, which in turn attracted better credits, thus reducing the overall risk profile of the Section 232 portfolio. If many of the new restrictions and requirements in the Proposed Regulations are implemented, HUD will lose its operational flexibility as well as discourage many well qualified borrowers and operators from participating in the 232 program. Therefore, HUD may quickly revert back to being the lender of last resort and borrowers with viable options, i.e. the more credit worthy borrowers, will seek non-HUD financing.[4]

As you know, the Supreme Court has just upheld a majority of the provisions of the Patient Protection and Affordable Care Act. Therefore, our healthcare system will continue to face significant changes in the coming years. We do not believe it is in HUD's best interest to lose its flexibility to adjust the Section 232 program as needed, which will inevitably happen if the Proposed Regulations are implemented. We believe HUD should follow its current course of constantly improving the Section 232 process through changes at the programmatic level. While not all of the programmatic changes implemented to date have been supported by the private sector, we do believe that the strong public-private partnership that HUD's collaborative process nurtured through LEAN has created a stronger and more stable Section 232 portfolio. That collaboration and communication will be stifled, and in many cases prohibited, if program matters become cemented in regulations.[5] We ask that HUD implement regulations only when needed to provide authority to take action on the program level, and do so in broad terms so that HUD maintains its flexibility.

Lastly, when the final regulations and loan documents are in fact published, we respectfully request that HUD make them effective no earlier than 180 days after publication and, more importantly, apply them to loans that were submitted for firm commitment application after that 180 day effective date. There is a significant lead time required to develop a Section 232 application and the lenders and borrowers must make decisions based on the rules and documents in effect at the time they are preparing the application. Therefore, if HUD makes the regulations and documents effective relatively soon after publication (e.g. 60 or 90 days), the Department will be changing the rules on many borrowers and lenders in the middle or near the end of the application preparation process. We believe this is not in the best interest of the

---

[4] As you know, even though the Section 232 program has seen tremendous growth, it is still a minor player and many new sources of financing have entered or reentered the market place. Therefore, HUD is not in a position of crowding out the private sector by continuing to grow the Section 232 program.

[5] As a point of reference, we point to the regulations implemented in 2009 for HUD's Section 242 program. Because the Section 242 program did not have a modern handbook and many Section 242 programmatic requirements were placed in the regulations, we have seen HUD's efforts to adapt that program to today's healthcare needs stifled and slowed.

Section 232 program and will undermine HUD's efforts to attract more credit worthy borrowers and operators.

II. Specific Comments to the Proposed Regulations

Before we discuss our concerns with the Proposed Regulations, we did want to acknowledge some of the many positives in the Proposed Regulations and the Proposed Loan Documents, which reflect the business realities of the long-term healthcare industry balanced with the need to protect the GI/SRI. We support the following provisions and believe they will enhance the operating efficiency and protection of the Section 232 program:

- The new definition and treatment of owner's surplus cash, which allows distributions any time with a 'true up' at the end of a semi-annual period if the owner happened to distribute too great an amount;

- Adding a debt service reserve as an eligible cost of the mortgage and eligible for refinancing; and

- Limiting REAC inspections to projects in states that don't have a reliable and adequate inspection program or, on a case-by-case basis, inspections when it is necessary to assure protection of residents or adequate preservation of the project.

While we could provide a more detailed analysis of the positive improvements in the Proposed Regulations and Proposed Loan Documents, we unfortunately have very little time to review all of the items published by HUD. In fact, we are concerned that, even working with other industry stakeholders to develop comments, HUD's comment period was too short to allow for proper public notice and comment. So, if we have not mentioned a particular provision, please do not feel that we are indifferent; it is just that we had no more time to develop comments. We do applaud HUD's initiative in implementing these program improvements as we have applauded other program adjustments during the implementation of LEAN over the past four years. The work done with industry partners and HUD's staff in both the Office of Healthcare Programs and the Office of Residential Care Facilities has created a program that is stronger and more efficient than prior to LEAN. It is under that spirit we offer the following comments to the Proposed Rule.

A. Debt Service Reserve Fund (Section 232.11)

HUD's most impactful change in the Proposed Regulations is the mandatory debt service reserve fund ("DSRF") requirement.[6] Our first concern with this new requirement is that there are no parameters by which the public can evaluate the proposed DSRF requirement. Because HUD has not published a draft handbook, the public is left to guess at HUD's funding

[6] *See* Section 232.11 of the Proposed Regulations.

requirements, which the Proposed Regulations state will be determined during HUD's underwriting. Therefore, we again ask that the Proposed Regulations be republished with a draft Section 232 handbook in order for the public to receive proper notice of HUD's new requirement and to evaluate the regulations in the context of the overall program.

Second, we strongly question the need for a "mandatory" DSRF for all projects for the life of the loan. HUD could (and should) modify proposed Section 232.11 to say that the DSRF will be required at the discretion of the Secretary. Then, a new Section 232 handbook would provide the circumstances when a DSRF would be required. By making the DSRF a mandatory, regulatory requirement, which must be held for the life of the loan, HUD will be limiting its staffs' ability to appropriately underwrite and structure Section 232 loans and the potential pool of applicants to the program. With discretionary power, it is highly likely that a HUD underwriter will determine that a specific project is a low credit risk and will want to structure the loan in manner that would encourage that low risk borrower to utilize the Section 232 program. If, however, the HUD underwriter must impose a DSRF even if they believe it is unnecessary, then HUD will be creating a program that imposes burdens its staff cannot justify to borrowers/operators, which will discourage the participation of credit worthy entities.

We understand that HUD believes a DSRF is needed to provide better protection for the insurance fund. However, HUD's comments in the Proposed Regulations show this is not the case. HUD stated that only five (5) Section 232 claims from 2009-2011 would have benefitted from having a DSRF and that HUD expects if the mandatory DSFR had been in place, two (2) fewer claims would have been made. In effect, HUD is mandating the restriction on millions of dollars over the course of decades, merely to protect less than 1% of its portfolio. In fact, HUD estimated that it could save $13 million per year and that those savings would be passed on to borrowers; however, HUD has not indicated in any way how this would occur. In fact, HUD is actually proposing to increase costs to the borrowers by raising the mortgage insurance premium in Fiscal Year 2013.

We believe that the cost-benefit analysis of this proposed requirement strongly supports not having a mandatory DSRF in the regulations. The Proposed Regulation estimates that borrowers must escrow $51 million in order to save $13 million. However, we think HUD's cost estimate is grossly understated. If HUD imposed an average 2% DSRF on each loan, that would result in $300 million of cash being escrowed (if applied to the entire HUD portfolio) to save $13 million. (Also, we question even the concept that this savings would, in fact, ultimately prevent the two cases from being assigned to HUD.) We fail to see how making the healthcare industry spend over 3 times (or in our estimate 25 times) HUD's estimated savings actually results in savings overall. (The investment opportunities lost to HUD's borrowers on the escrowed money could easily be larger than any potential savings to HUD.) Further, HUD has failed to include in its analysis that impact of the Section 232 program's credit scoring on the GI/SRI. Because the Section 232 program maintains a consistent negative credit subsidy, and that scoring will improve by more than two-fold if the mortgage insurance premium is raised[7], we believe that the

[7] *See* the Federal Notice published as Docket No. FR-5634-N-01 and the Committee's comments thereto.

Section 232 program has enough protection and HUD does not need to engage in disproportionately expensive risk mitigation.

Over the past four years, the Section 232 program's credit profile has greatly improved largely because of efforts done at the programmatic level. HUD now requires a deposit account control agreement in order to protect cash flow in a defaulted project. By allowing accounts receivable lending, HUD has its borrowers/operators much needed liquidity that enables facilities to continue operations with delayed reimbursements. HUD's use of the master lease provides tremendous leverage over borrowers/operators to encourage their use of stronger properties for the benefit of weaker ones. All these measures have had real positive results and have been implemented with participation from the industry at the programmatic level. We think that other risk mitigation tools, such as the DSRF, are better handled at the programmatic level and should not be mandated in the regulations. We also point out that the five (5) claims identified in the Proposed Regulations background section did not have the benefit of these new protocols, and HUD would be better served to evaluate the success of the LEAN program over the next few years before creating what may be counter-productive requirements.

B. Operator Restrictions

1. Single Asset Requirement (Section 232-1003) - The Proposed Regulations impose several new restrictions on operators that we believe will rightly discourage participation in the Section 232 program by experienced and sophisticated operators. First, Section 232.1003 mandates that operators be single-asset entities. This is a new, and highly problematic, requirement that should be removed in the final regulations. Many of the top-level operators do not create single purpose entities for each facility they lease/operate. By requiring them to do so, HUD will prompt a significant reorganization in the long-term care industry. We believe operators will be reluctant to undertake the costly and time consuming burden of creating multiple entities, transferring licenses, and undertaking complex regulatory processes that will be necessary if HUD insists on sole-purpose operators. (There may also be tax implications and tremendous real estate costs to transfer property to new single-asset entities.) The exodus of well-capitalized, experienced, and successful operators – which is certain to happen if HUD imposes this restriction – will leave HUD with the borrowers and operators who are unable to obtain viable financing elsewhere. As we stated above, HUD's efforts over the last few years have improved the quality of the participants involved in the Section 232 program. HUD should not impose rules that will discourage participation in the Section 232 program without providing justifications for such requirements. In fact, HUD's own experience with the use of Master Leases and control agreements should indicate that such a drastic step as mandating single-asset operators is unnecessary to protect HUD's collateral.

2. Separate Deposit Accounts (232.1005(a) and 232-1017(a)) – We request that HUD delete the requirement that an operator's deposit account must be held "in the name of the single asset operator." This is contrary to the industry standards and HUD's current guidelines. HUD's own accounts receivable (A/R) financing regulations acknowledge that cash from multiple facilities is all commingled into a single operator account. The key focus should not be on the bank account

but should be on the accounting in place to track the funds. Operators must be sufficiently sophisticated to track funds through their accounting. HUD is and will continue to be protected by having the deposit account control agreements in place. Therefore, having segregated accounts provides no appreciable benefit to HUD. It does, however, increase the costs to operators for every HUD-insured loan because the costs of opening and maintaining a new account, plus the annual costs that banks are now charging for each control agreement, will further increase the costs and burdens (and thus decrease the attractiveness of) the Section 232 program. Because HUD requires a control agreement, this separate account requirement poses significant costs on the borrowers and operators with little to no benefit to HUD, and we believe this requirement is counterproductive. As a suggestion, HUD could mandate as part of the underwriting that the lender or a consultant retained by the lender perform an analysis of an operator's accounting systems to determine that they are sufficiently sophisticated to produce financial statements on a facility by facility basis for any portfolio operators.

3. Commingling of Operator Funds (232-1005(b)) – We believe HUD's proposed restriction on the comingling of operators' funds conflicts with HUD's current practice and will interfere with a successful implementation of both the master lease program and accounts receivable financing for HUD projects. It is quite common for operators to use concentration accounts to hold various project funds. Funds can and should be tracked via appropriate record keeping. Further, if a project is in financial trouble, HUD and the Lender can use the control agreements to stop project funds moving into a concentration account. We stress again the importance, from a risk mitigation perspective, of HUD evaluating how the Proposed Regulations will encourage or discourage higher quality borrowers and operators' participation in the Section 232 program. We believe this restriction is just another example of HUD's causing operators to restructure in a way that many will refuse to do. Thus, HUD will be less able to diversify its portfolio as experienced, sophisticated operators refuse to participate in the Section 232 program.

4. Working Capital Requirement (232.1017(B)) – HUD's proposed requirement that operators maintain positive working capital at all times ignores the reality of how nursing homes, etc. operate. Many times operators will have short term cash flow shortages but over the course of a week, month, or quarter would have positive working capital. Therefore, we request that HUD amend this requirement to state that the operator maintain working capital as the Secretary may proscribe. Then, in the Section 232 handbook, HUD can develop a more comprehensive policy on working capital requirements that can more easily adjust as the industry changes over the years. An option at a handbook level would be to change the definition of working capital to include all accounts receivable (regardless of age) and to change the requirement as posted to be a look-back similar to the proposed surplus cash regulation for owners (i.e. not a violation, but simply a replenishment if funds were taken while the operator was not solvent).

C. Miscellaneous

1. Section 232-1009 – We believe that HUD should not prohibit borrowers from paying a salary to a principal. In many smaller operations, i.e. the "mom and pop" facilities, family members are the key to a successful operation. By adopting this rule, HUD will be excluding

from the Section 232 program HUD's historical base of borrowers. We do not believe this keeps within the Congressional mandate to provide affordable financing for those facilities least able to access capital. Instead of making this requirement a regulatory prohibition, we ask HUD to provide the Secretary authority to develop guidelines for paying a salary to a principal. Then, in the Section 232 handbook, HUD can develop, with industry participation, standards that must be met if a borrower pays a salary to a principal.

2. Section 207.258 – We see that HUD has proposed changing the insurance claim process for all insurance programs under Part 207, which includes the Section 242 hospital program, in addition to Section 232. We believe that change violates the National Housing Act and such a global change to other programs should not be hidden within Proposed Regulations identified for Section 232. Currently, if a lender elects to assign the mortgage to the Commissioner, the lender must, within 30 days after the date of the notice of the election, file its application for insurance benefits and assign the mortgage to the Commissioner.[8] HUD now proposes to change that process so that a lender may not file its application for insurance benefits and assign the mortgage to the Commissioner until "HUD acknowledges the notice of election."[9] Therefore, HUD would have the ability to delay payment of an insurance claim merely by refusing to provide acknowledgement of the notice. We believe this undercuts the incontestability of the FHA insurance, as provided for in Section 8(e) of the National Housing Act (12 U.S.C. 1706c(e)), by implementing a practical barrier to the realization of the lender's insurance benefits. This new requirement allows HUD to deny benefits to a lender even though the lender has not failed to follow any claims processing requirement. We respectfully request that the Section 207.258(b)(1)(i) of the Proposed Regulation be deleted.

3. Section 232.903(c)(2)(iii) and (d)(3) – There is a cross reference to Section 232.15 but there is no Section 232.15. Did HUD actually intent to reference 24 C.F.R. Section 200.41?

III. Conclusion

As stated above, the Coalition supports HUD's efforts to improve the Section 232 program and we appreciate the opportunity to work with the Department to develop standards and processes that provide affordable financing for long-term health care provide while also protecting the U.S. taxpayer and the GI/SRI. HUD's Section 232 LEAN program was a great example of the public and private sectors working together to develop and effect a program that serves a Congressionally mandated mission while also protecting the taxpayer against unnecessary risk. Some of the improvements of LEAN are: consistent underwriting, better trained staff, less leveraged loans/projects, increased control over cash through A/R financing and a springing lockboxes, master leases, Debt Service Reserve Funds when needed, and operator reviews. The consistency of underwriting and predictable outcomes have attracted higher quality borrowers who will be better able to adapt to and withstand the changing landscape of healthcare in the United States.

---

[8] *See* 24 C.F.R. 207.258(b).
[9] *See* Proposed Regulation 207.258(b)(1)(i).

All of these positive changes would have been impossible if the Proposed Regulations and the Proposed Loan Documents had been in place. So, we ask the Department to seriously consider our comments and work with the Coalition to amend the Proposed Regulations and the Proposed Loan Documents so that our efforts will result in the continuous improvement of the Section 232 program.

Very truly yours,

Roderick D. Owens
Krooth & Altman LLP
Counsel to the
Committee on Healthcare Financing

Anthony Luzzi
Sims Mortgage Funding, Inc.
Chair, Section 232 Working Group
Mortgage Bankers Association

On behalf of the Coalition of:

American Health Care Association
American Seniors Housing Association
Assisted Living Federation of America
LeadingAge
National Center for Assisted Living