U.S. Department of Housing and Urban Development
Office of Housing

Special Attention of:

Secretary Representatives
Area Coordinators, Community Builders, Multifamily Hub Directors, Multifamily Program Center Directors, Multifamily Housing Representatives, Mortgage Credit Examiners, A&E and Cost Analysts, and Valuation Processors

Notice **H** 01-03 (HUD)

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Cross References:
Multifamily Accelerated Processing (MAP) Guide
HUD Handbook 4600.1 REV 01
Supersedes Mortgagee Letter 00-42

Subject: Review of Health Care Facility Portfolios and Changes to the Section 232 Programs

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Distribution: W-3-1.

I. BACKGROUND.

On November 6, 2000, HUD issued Mortgagee Letter 00-42, Subject: “Headquarters Review of Certain Applications for Section 232 Mortgage Insurance." The Mortgagee Letter announced a special Headquarters review of certain Section 232 mortgage insurance applications. Multifamily Hubs and Program Centers are experiencing unprecedented interest from mortgagees and health care owner/operators in the Section 232 mortgage insurance program for nursing homes, intermediate care facilities, board and care homes and assisted living facilities. The major reason for this interest is the health care industry's financial uncertainty resulting in a limited availability of capital.

FHA recognizes its traditional role as a credit enhancer in times of tightening mortgage capital availability. However, we also need to protect the financial viability of the FHA General and Special Risk Insurance funds and be certain that any Section 232 insured loan is economically sound. Therefore, we have reviewed our policies and procedures and are making certain changes to the Section 232 programs. Changes in processing procedures in this notice are designed to reflect changing conditions in the health care industry and adequately protect the FHA insurance funds.

The procedures contained here apply to proprietary and nonprofit owners and operators of health care facilities and their affiliates where there is:

- An application for mortgage insurance involving new construction or substantial rehabilitation;
- An application for mortgage insurance for purchasing or refinancing an existing facility;
- A transfer of physical assets (TPA); or
- A change in the lessee or management agent of a facility.

II. MULTIFAMILY ACCELERATED PROCESSING PROGRAM RESTRICTIONS.

The Multifamily Accelerated Processing (MAP) Program is available for financing health care facilities. However, not all MAP Lenders have the experience necessary to underwrite the specialized limited use real estate.

A. The MAP Lender's underwriter must have, within the previous 5 years, experience in underwriting the development and operation/management of health care facilities.

1. The underwriter's detailed resume must demonstrate this specific experience.

2. The resume is submitted to the Lender Qualifications and Monitoring Division (LQMD) of the office of Multifamily Development in Headquarters for review and approval.

B. Any MAP Lender, whose underwriter cannot demonstrate the necessary level of experience, must use Traditional Application Processing (TAP) Program when financing its health care facility projects.

III. BANKRUPTCY.

Any owner or operator of a healthcare facility or their affiliate or renamed or reformulated company that has ***filed for, is in, or has emerged from*** bankruptcy within the last five years ***is not eligible to participate*** in any manner in a facility which is the subject of a mortgage insured through the Section 232 Mortgage Insurance for Health Care Facilities Programs.

A project in bankruptcy that is acquired by a nonidentity-of-interest owner in good standing is eligible for mortgage insurance.

Any exception to this requirement must be approved by HUD Headquarters.

IV. PORTFOLIO TRANSACTIONS.

A number of national and regional health care operators and owners have indicated an interest in using HUD programs to construct, rehabilitate, refinance or purchase health care facilities. Because the business aspects of these transactions so differ from HUD's core multifamily business we are establishing an additional level of review.

A. Large Portfolios.

1. Definition: The owner/operator is seeking mortgage insurance financing under the Section 232 Program for either:

   - ***Fifty or more projects*** within any 18 month period; or

- o Combined estimated mortgage amounts in excess of $250,000,000.

The 18 month time clock starts with the first transaction to be processed under this notice.

2. The owner/operator must purchase the three part product described in Section V. below from one of the three Wall Street Rating Agencies [Standard & Poor's, Moody's Investors Service and Fitch IBCA, Duff & Phelps].

3. The owner or operator may choose to refinance its entire portfolio at one time or in stages.

In either case, HUD Headquarters will perform a mortgage credit review before any application is submitted for processing to a Hub Office. If the HUD Headquarters review is favorable, then applications for individual projects may be submitted to the Hub with jurisdiction for processing.

B. Midsize Portfolios.

1. Definition: The owner/operator is seeking mortgage insurance financing under the Section 232 Program for:

- o **Eleven to *forty-nine projects*** within any 18 month period; and

- o Combined estimated mortgage amounts equal to or in excess of $75,000,100 up to $250,000,000.

The 18 month time clock starts with the first transaction to be processed under this notice.

2. The owner/operator receives a modified review detailed below.

a. Corporate Credit Analysis.

The owner/operator must purchase a corporate credit analysis, as described in V.B. below, from the rating agency of their choice.

HUD Headquarters will perform a mortgage credit review before any application is submitted for processing to a Hub Office. If the HUD Headquarters review is favorable, then applications for individual projects may be submitted to the Hub with jurisdiction.

3. Site visit.

   The project specific site visit will be performed as part of the normal MAP or TAP commitment processing.

C. Small Portfolios.

1. Definition: The owner/operator is seeking mortgage insurance financing under the Section 232 Program for:

   - o ***Up to ten projects*** within any 18 month period; and
   - o Combined estimated mortgage amounts up to $75,000,000.

   The 18 month time clock starts with the first transaction to be processed under this notice.

2. HUD will, without Headquarters review, process applications for mortgage insurance using regular MAP or TAP instructions.

D. Required Owner/Operator Certification.

Each current and proposed health care operator or its affiliate (whether as a mortgagor, sponsor, principal as defined by FHA Previous Participation (2530) - or lessee) who has submitted or proposes to submit a pre-application or an application for Section 232 mortgage insurance must also submit a certification.

1. The Certification must show:

   => The number, location and estimated mortgage amount of all actual or potential pre-applications and applications for mortgage insurance to be submitted to HUD within any 18 month period; and

⇒ Their level of involvement in the proposed project.

2. The certification must contain the following language: "HUD will prosecute false claims and statements. Convictions may result in criminal and/or civil penalties. (18 U.S.C. 1001, 1010, 1012; 31 U.S.C. 3729, 3802)"

3. The certifications are to be submitted to:

   a. Headquarters when the proposed health care provider and its affiliates) have submitted or plan to submit preapplications and/or applications for Section 232 mortgage insurance to finance or refinance a ***large or midsize portfolio.***

   b. The Hub or Program Center Office when the proposed health care provider and its affiliates) have submitted or plan to submit pre-applications and/or applications for Section 232 mortgage insurance to finance or refinance a ***small portfolio.***

V. STANDARDIZED CREDIT ANALYSIS PRODUCT FROM A RATING AGENCY.

To assist the Department in making portfolio loans, we have asked the rating agencies [Standard & Poor’s, Moody's Investors Service and Fitch IBCA, Duff & Phelps] to develop a standardized credit analysis product for portfolio health care facilities.

A. Overview.

1. The Product is comprised of three parts.

   a. The Corporate Credit Analysis;

   b. The Site Visit; and

   c. The Status and Performance Review of Properties and Lines of Business not coming to HUD for financing.

2. It is the responsibility of the Borrower or Lender to have these analyses performed and to pay for the analyses.

3. The cost of the credit analyses is a mortgageable item included in other fees. It is spread over the projects seeking mortgage insurance over the 18 month period based on either a per unit amount or a per bed amount.

B. Corporate Credit Analysis.

This review of the parent entity looks at each of the business lines to establish a comfort level with the company in question. HUD needs to understand the possibility that the company may be shortly entering bankruptcy. HUD is looking for a yes or no recommendation for HUD to do business with the company.

If the company plans include multiyear financing of large or midsize portfolios with FHA insurance, the company should contract for ongoing corporate credit surveillance by the rating agency on no less than an annual basis.

1. The rating agency corporate due diligence analysis includes:

   a. Looking at:

      - The company's key operating and financial plans;
      - The financial strength of the company;
      - The management policies;
      - The legal structure of the company;
      - The strength of management; and
      - The overall capacity of the company to perform at various levels including internal quality control.

   b. Material submitted by the owner/operator to the rating agency before meeting with the owner/operator's upper management.

      - Five years of audited financial statements;
      - Interim financial statements;
      - Narrative description of operations and products;
      - operating and financial forecasts; Copy of charter and bylaws, or constitution, as currently amended;

- An explanation of the management structure;
- A list of officers and directors or trustees of the company including names, Social Security Numbers or Employer Identification Numbers, addresses and titles of positions;
- Current resumes on the company and principals and operating officers of the company;
- Credit reports on the company and its operating officers;
- Relevant industry information; and Written presentations by management, ***not mandatory.***

c. Meeting with the owner/operator's upper management.

The rating agency will meet with the Chief Financial Officer and Chief Executive Officer of the owner/operator to discuss the past, present and future financial outlook of the company. Topics to be discussed include:

- Corporate Strategy
- Acquisition Strategy
- Organizational Structure
- Company Operations
- Industry Outlook
- Competitive Position
- Financial Strategies
- Profitability
- Cash Flow-Generating Ability
- Capital Structure
- Financial Flexibility
- Risk Management

d. Preparing financial analysis that looks at leverage ratios and cash flows; and running scenarios on future cash flows.

2. The corporate rating committee or similar type organization within the rating agency reviews the findings and draft report.

3. The owner/operator is notified of the findings and major considerations supporting it. The owner/operator can appeal the findings to the rating

agency before issuance of the final report, if important new or additional information is presented. However, there is no guarantee that any new information will alter the final decision.

4. The final report is considered confidential and is disclosed only to parties designated by the owner/operator. To the extent the owner/operator proceeds with any transactions, the owner/operator will provide a copy of the final report to the mortgagee as well as to HUD.

C. Site visit.

Every existing project in the portfolio to be financed ***using the Section 232 Program*** will receive a site visit from the Commercial Mortgage Backed Securities (CMBS) Team of the rating agency.

1. The owner or operator will make available to the CMBS Team the following third party reports, ***if available*****,** before the scheduled site visit:

    - The Appraisal Report
    - The Engineering Report - may include a structural engineering report.
    - Phase I Environmental Report
    - Seismic Report
    - Market Analyses
    - Credit Reports
    - Copies of the bank and trade reference inquiries and their results

2. The owner/operator ***must provide*** the following material to the CMBS Team before the scheduled site visit:

    - A year-to-date balance sheet and operating statement of the facility.
    - Three years of audited financial statements [operating history] of the facility, if available, or owner certified financial statements or cost reports (as required by Medicare and Medicaid) of the facility.
    - Expense budget.

- Copy of the legal structure including all board members and operating officers of the ownership entity.
- Project's mission statement.
- A copy of the last three years loan payment history.
- List of major capital improvements made during the last three years or planned including the total amount spent and/or budgeted.
- Current rent/bed roll.
- A three year history of payor mix.
- State licensing surveys [inspection reports] for the past three years which address:
  - ⇒ Quality of care issues;
  - ⇒ Citations of previous uncorrected findings; and
  - ⇒ Civil money penalties imposed on the site
- Composition of staff including salary, benefits and training offered.
- Detailed explanation of any purchase of goods and/or services from identity of interest firms.
- Discussion of outstanding Federal or State litigation involving fraud or abuse as it relates to public money.
- Inventory of existing or planned providers in the project's primary service area [a five-mile radius] in terms of:
  - ⇒ Number of beds/units
  - ⇒ Occupancy levels
  - ⇒ Payor Mix
  - ⇒ Private-pay rates
  - ⇒ Level of services provided
  - ⇒ Group affiliations
  - ⇒ Distance from the project
  - ⇒ Ownership status
  - ⇒ Facility appearance
- Occupancy rates for the past three years.
- Marketing programs including affiliations with other organizations.

3. The site inspection includes:

- A walk through the facility;

- A meeting with management especially the head of nursing;
- Meeting with the residents and family members concerning their feelings towards the facility and management;
- Mix of beds - private pay, Medicare and Medicaid or mix of unit types;
- Determining how modern the facility is from a competitive standpoint; and
- Looking for signs of deferred maintenance.

4. The site visit report provides:

   a. A financial analysis of the three years of financial statements and the current financial statement for the facility. This includes seeing if:

      - The accounts receivable are received promptly or slowly;
      - The accounts payable are paid promptly or slowly;
      - There are any accounts receivable from or accounts payable to employees or principals of the entity or affiliates; and
      - The project's net cash flow is adequate to sustain the project into the future.

   b. Details of the current reimbursement rates.

   c. Analysis of the facility's marketing plan.

      - Occupancy trends.
      - Census analysis of the area's demographics.

   d. Discussion of the quality of the real estate:

      - Issue of functional obsolescence.
      - Fire and safety citations.
      - Major building components including structures, mechanical systems, roof, siding etc.

   e. Discussion of staffing levels:

      - Salaries
      - Benefits
      - Training and advancement opportunities
      - Employee turnover rate
      - Use temporary employees and its implications; and
      - Key vacancies

   f. Economic analysis of the State and local economy.

g. Strengths and risk concerns inherent in the project and its management.

5. The report will assign a quality rating to the management, market, physical condition of the facility and the net cash flow of the facility.

Note: ***The site visit and report does not relieve HUD [MAP Lender] from completing its own visit and technical review.***

D. Status and Performance Review of Properties and Lines of Business not coming to HUD for Refinancing.

1. This is a desk review of all other properties and lines of business not being financed with FHA mortgage insurance. The review is to determine event risk of the non-FHA pool assets. The review includes a financial analysis of the properties to assure HUD that they would not be a financial drain on the insured properties. The analysis looks at net cash flows, debt service coverage and credit worthiness of the entity and its owner.

2. If the rating agency finds something troubling then they will perform a more in-depth analysis.

VI. SUBMISSION OF THE RATING AGENCY REVIEW.

The owner/operator may submit the credit analysis to the office of Multifamily Development:

A. Before or simultaneously with the owner/operator approaching an FHA approved lender; and

B. Before any applications for mortgage insurance is submitted to Hub Office with jurisdiction.

VII. MATERIALS TO BE SUBMITTED TO HEADQUARTERS.

A. Large Portfolio Transactions.

1. The standardized three part credit analysis product.

2. All supporting documentation provided the rating agency.

3. Form HUD 2530 on the owner, the operator and their affiliates.

4. Owner/operator certification [see Section III.D.].

B. Midsize Portfolios

1. The corporate credit analysis portion of the standardized three part credit analysis.

2. All supporting documentation provided the rating agency as part of the corporate credit analysis.

3. Form HUD 2530 on the owner, the operator and their affiliates.

4. Owner/operator certification [see Section III.D.].

VIII. VACANCY AND COLLECTION LOSSES.

A. HUD's [MAP Lender's] appraiser must establish a vacancy and collection loss factor when determining the effective gross annual income for the health care facility.

B. For a Section 232 pursuant to Section 223(f) project the vacancy and collection loss rate used in processing is the greater of:

1. The actual vacancy percentage at the health care facility; or

2. Five percent; or

3. Current vacancy percentage of the local market based on market comparables and market conditions.

IX. CROSS COLLATERALIZATION AND DEFAULT PROVISIONS FOR FACILITIES IN A PORTFOLIO TRANSACTION.

It is the Department's ***intention*** to issue interim regulations requiring each mortgagor entity, operator and mortgagee involved with refinancing a portfolio health care projects to enter into a cross collateralization and default agreement.

A. Under the Agreement a default in one project, at HUD's option, triggers a default in one or more of the other projects in the pool.

B. The option to declare other project(s) in default rests with Office of Asset Management, in Headquarters.

X. LIABILITY INSURANCE.

Liability insurance premiums are increasing at an alarming rate in some States in the country. In addition, because of today's litigious environment, a number of carriers of liability insurance products have decided to stop underwriting policies in certain States.

Nevertheless, HUD requires health care facilities to maintain liability insurance. Failure to do so is a technical default under the terms and conditions of the mortgage insurance contract. Therefore, we are taking the following steps to protect the insurance fund.

When mortgage underwriting is performed by HUD [MAP Lender], the current prevailing premium rates in that State, at a minimum, must be used along with reasonable deductible levels, and adequate coverage levels. Therefore, HUD strongly urges Mortgagees to take these factors into consideration when preparing their mortgage insurance applications.

XI. PROPERTY INSURANCE REQUIREMENTS.

Amend Form FHA 2447, Property Insurance Requirements, by attaching Appendix 2, Updated and Additional Property Insurance Requirements.

XII. SINGLE ASSET MORTGAGOR ENTITY.

The mortgage property must be the only asset of the mortgagor(borrower).

XIII. FOR FURTHER INFORMATION.

If you have questions concerning this Notice feel free to contact the Office of Multifamily Development at (202) 708-1142.

Note: The requirements outlined in this Notice may not be waived by the Hub or Program Center Director.

Sean G. Cassidy
General Deputy Assistant Secretary
for Housing - Deputy Federal Housing
Commissioner

Attachment

DEFINITIONS

Affiliate. Persons and entities are affiliates of each other if, directly or indirectly, either one controls or has the power to control the other, or, a third person controls or has the power to control both. Indicia of control include, but are not limited to: interlocking management or ownership, identity of interests among family members, shared facilities and equipment, common use of employees, or a business entity organized following the suspension or debarment of a person which or entity has the same or similar management, ownership, or principle employees as the suspended, debarred, ineligible, or voluntarily excluded person or entity.

Assisted Living Facility. A public facility, proprietary facility, or facility of a private non-profit corporation that is licensed and regulated by the State, municipality or other political subdivision where the Project is located. The facility must make available to the residents supportive services necessary to carry out activities of daily living, provide separate dwelling units for the residents and facilities appropriate for the provision of supportive services.

Bed Authority. Any and all rights and documentation pertaining to the maximum number of beds allowed, including certificates of need (CoN) where issued, required by and granted to be granted by the State of jurisdiction and its political subdivisions for operation of the project.

Board and Care Home. A proprietary residential facility or a residential facility owned by a private nonprofit corporation or association that provides room, board and continuous protective oversight and which facility is regulated by a State.

Governmental Approval. Any license, permit or certificate of need or other approval, necessary and required by the State or the municipality or other political subdivision in which the facility is located in order to operate the Project and to receive benefits under a provider agreement with Medicaid, Medicare or other assistance required by HUD's commitment to insure the Security Instrument.

Health Care Facility. A Project insured under the National Housing Act, as amended and includes but is not limited to nursing homes, intermediate care facilities, board and care homes, assisted living facilities, and any combination of the above.

Intermediate Care Facility. A proprietary facility or a facility of a private nonprofit corporation or association licensed or regulated by the State, municipality or political subdivision where the facility is located. The facility must provide for the accommodation of persons who because of incapacitating infirmities, require minimum, but continuous care, and are not in need of continuous medical or nursing services.

Lessee of a Health Care Facility, Lessee. An entity which has a lease or other agreement with the Mortgagor to operate and manage a Health Care Facility to provide housing, medical and related services that are proper and necessary for the care and treatment of the residents.

Lessor. The Owner of real or personal property who gives another the right to use it in return for rental payments. Also called the Mortgagor.

Mortgagor. All persons or entities identified as "Mortgagor" in the first paragraph of the Security Instrument, together with its successors and assigns. Mortgagor shall include any person or entity taking title to the Mortgaged Property whether or not such person or entity assumes the Note.

Nursing Home. A public facility, proprietary facility or a facility owned by a private nonprofit corporation or association licensed or regulated by the State, municipality or political subdivision where the facility is located, for the accommodation of convalescents or other persons who are not acutely ill and not in need of hospital care but who require skilled nursing and related medical services which are prescribed by or under the direction of persons licensed by the laws of the State where the facility is located. In addition the term nursing home and intermediate care facility may include such additional facilities as may be authorized by HUD for the nonresidential care of elderly individuals and others who are able to live independently, but who require care during the day.

Operator. The entity that operates the health care business. The operator may be the mortgagor or lessee.

Owner. The Mortgagor and/or Affiliate.

Project. A Health Care Facility and land on which the improvements are situated and all major movable and other equipment necessary for operation as a Health Care Facility.

Project Revenue. All income derived from private pay, benefits and reimbursements under provider agreements with Medicaid, Medicare, State and local programs, payments from health care insurers and any other assistance providers, all rents, charges and fees received from leasing space on the Mortgaged Property, all contributions, donations, gifts, grants, bequests and endowment funds by donors and all other revenues received from any source paid or unpaid, including but not limited to all accounts receivable, undisbursed funds in Surplus Cash, Residual Receipts, escrow accounts and other assistance available for Project operation.

Proprietary Facility. A facility owned by a profit motivated owner which may be a corporation, partnership, limited liability company, trust or any other qualified legal entity.

Public Facility. The facility is owned by a Federal or State instrumentality, a municipal corporation instrumentality or one or more States, or a redevelopment housing corporation formed under and restricted by Federal or State laws or regulations of a State department, such as a banking or insurance department as to charges, capital structure, rate of return, or methods of operation.

APPENDIX 2 02/06/01

UPDATED AND ADDITIONAL PROPERTY INSURANCE REQUIREMENTS

I. Insurance During Construction.

A. Public Liability Insurance on a Commercial General Liability form with limits of not less than $500,000 per occurrence to protect the Owner during the construction phase from claims involving bodily injury and/or death and damage to the property of others. Such Commercial General Liability Insurance shall be endorsed to include owners' and contractors' protective coverage.

B. Vehicle Liability Insurance with limits of not less than $300,000 for one person and $500,000 for more than one person to protect the Owners for claims for bodily injury and/or death, and not less than $100,000 against claims for damage to property of others arising from the owner's operation of vehicles. Such insurance shall include coverage for employer's owned, non-owned and/or hired vehicles, where applicable.

II. Permanent Insurance

Upon acceptance of the project, or any portion thereof from the contractor, the owner shall provide a certified duplicate copy of the following insurance coverage. In some instances, continuation of the insurance obtained for the construction period, with proper endorsements thereto, will be acceptable. In any event, the Owner shall assure that there is no gap period in insurance protection during the transition from the Insurance During Construction to the Permanent Insurance.

A. Public Liability Insurance on a Commercial General Liability form with limits of not less than $500,000 per occurrence protect to the Owner from claims involving bodily injury and/or death and property damage which may arise from the Owner's operations, including any use or occupancy of its facilities, grounds and structures, and shall include independent contractors coverage, where applicable.

B. Vehicle Liability Insurance. If the Owner owns or a vehicle in the operation of the project, including non-owned and/or hired vehicles operated for the benefit of the

Owner, the Owner shall procure and maintain Vehicle Liability Insurance. Such insurance shall provide for limits of liability of not less than $300,000 for one person and $500,000 for more than one person to protect the owner from claims for bodily injury and/or death, and not less than $100,000 against claims for damage to property of others.