U. S. Department of Housing and Urban Development
Office of the Inspector General for Audit
Northwest/Alaska Region 10
909 First Avenue, Suite 126
Seattle, WA 98104-1000
Phone 206-220-5360
Fax 206-220-5159

MEMORANDUM NO:
2002-SE-0803

September 30, 2002

MEMORANDUM FOR: Reneé D. Greenman, Director
Northwest Alaska Multifamily Hub, 0AH

//Signed//
FROM: Frank E. Baca, Regional Inspector General for Audit, 0AGA

SUBJECT: Review of HUD's approval of an insured mortgage for a Section 232 Project
J.A.M. Davis Incorporated, doing business as Loganhurst Health Care
Spokane, Washington

INTRODUCTION

We have completed a review of the Seattle Office of Housing's[1] approval of an insured mortgage for the Loganhurst Health Care residential facility.

The purpose of our review was to determine if HUD's Seattle Office of Housing followed HUD's mortgage credit requirements and prudent underwriting practices when reviewing and approving the application for insurance on the $3,995,000 Section 232 loan for the Loganhurst Health Care facility.

We originally began our review following a request by the Seattle Multifamily Hub to secure Loganhurst's financial records and perform a preliminary analysis of the project's cash disbursements. This analysis indicated that Loganhurst's financial troubles were apparent even before the approval of its Section 232 loan leading us to perform a review and analysis of the loan underwriting process.

[1] In early 1998, subsequent to the Seattle Office of Housing's underwriting and approval of the Loganhurst loan, HUD reorganized its multifamily production operations. Since the reorganization, all multifamily production for the Northwest/Alaska District has been handled by the Northwest/Alaska Multifamily Hub.

METHODOLOGY AND SCOPE

To accomplish our objective, we:

- Reviewed HUD handbooks to determine mortgage credit requirements;
- Interviewed HUD Seattle Office of Housing staff;
- Obtained and reviewed disclosures made to HUD by J.A.M. Davis representatives prior to firm commitment;
- Obtained and reviewed documentation of debt applicable to J.A.M. Davis and/or the principal owner;
- Verified if all material debt and adverse credit items were disclosed to HUD prior to firm commitment;
- Obtained and reviewed documentation of debt and adverse credit items disclosed to Hoover Mortgage prior to firm commitment; and
- Determined if diversions occurred, the nature of the diversions, and the solvency of principal parties.

We performed our review at the Seattle HUD office, the Loganhurst Health Care facility, and Hoover Mortgage at various times from May 2001 to January 2002, and covered the period from July 1994 to May 2001.

Should you or your staff have any questions, please contact me at 206-220-5360.

BACKGROUND

The purpose of Section 232 is to conserve and increase the supply of residential care facilities by providing mortgage insurance. The HUD Field Offices are responsible for assuring that processing and underwriting is carried out in accordance with the program regulations and instructions. FHA-approved multifamily lenders (mortgagees) submit applications for conditional and firm commitment on behalf of prospective borrowers (mortgagors) to the HUD Field Office.

The Davis family had been operating a nursing home in Spokane, Washington for over fifty years. In 1982, Florence Davis Reynolds (principal owner) took over as principal owner and administrator of the nursing home business. Prior to building its new facility, the Davis family operated a 45-bed nursing home that occupied the old Turner Mansion, which was built in the early 1900s. Over the years, the name of the business changed from Davis Nursing to Davis Convalescent, and then to St. Jude's Health Care. In 1990, St. Jude's filed bankruptcy because of problems with the Washington State Department of Social and Health Services (DSHS) and bad business decisions. The business bankruptcy led to a personal Chapter 13 bankruptcy for the principal owner and the formation of J.A.M. Davis Inc. with her three sons. J.A.M. Davis began doing business as Loganhurst Health Care and took over the operation of the nursing home with the principal owner as Loganhurst's administrator. The certificate of need for the nursing home was transferred from St. Jude's to the new corporation in 1991.

In July 1994, J.A.M. Davis applied for a $2.2 million HUD-insured loan to construct a new 45-bed nursing home facility adjacent to the Turner Mansion site. Hoover Mortgage Company submitted the application for Site Appraisal and Market Analysis (SAMA) for the new project to the HUD Seattle Office of Housing on behalf of J.A.M. Davis. The SAMA application expired and Hoover submitted a replacement SAMA application for a $3.8 million loan in August 1996. In September 1996, the Seattle Multifamily Production Branch Chief sent a rejection letter to Hoover stating: "We are not confident that a nursing home with only 45 beds can efficiently and effectively serve high acuity patients."

Hoover appealed the rejection and HUD reconsidered. In November of 1996 HUD requested an in-depth market study and business plan, and in April 1997 HUD found the modified SAMA application worthy of further consideration. In July 1997 Hoover submitted an application for firm commitment on behalf of J.A.M. Davis. By the end of 1997 HUD issued a firm commitment and initial endorsement for the mortgage insurance. Residents of the old Turner Mansion facility were moved into the new building upon completion of its construction in July 1999. HUD issued a final endorsement for insurance on the $3,995,000 mortgage on October 12, 2000.

Upon the opening of the new facility, the principal owner of J.A.M. Davis Inc., who was also Loganhurst's administrator, began diverting scarce operating funds in violation of the regulatory agreement. The diversions were primarily related to the repayment of debt that was disclosed to HUD prior to firm commitment. Apparently, J.A.M. Davis' principal owner repaid debts, including stockholder loans and interim financing that had given J.A.M. Davis the appearance of a debt-free entity with cash reserves. The project had no surplus cash at the time of the diversions. The diversions ultimately led to the project's inability to make timely payments for its mortgage, employee taxes and benefits, and vendors. From October 2000 to February 2001, the Washington State Department of Social and Health Services (DSHS) cited Loganhurst six times for putting patients in immediate jeopardy. According to the head of nursing home licensing for DSHS, most of the problems stemmed from Loganhurst's poor financial performance. In April 2001, DSHS hired a temporary manager to oversee the operations of the nursing home; however, the temporary manager found that the severe financial problems prohibited the nursing home from continuing to care for residents. Citing these financial difficulties, the Washington DSHS determined that the safety of the residents was in jeopardy, and on May 7, 2001, revoked Loganhurst's license. This resulted in the removal of the residents, closure of the nursing home facility and ultimately a default of the Section 232 mortgage. The loan was assigned to HUD on June 20, 2001 and is currently in the foreclosure process. The amount of loss will be determined upon completion of the foreclosure and disposition of the project.

RESULTS OF REVIEW

The Seattle Office of Housing approved insurance for a $3,995,000 loan for a residential care facility that was financially unstable. This occurred because HUD staff did not fully follow the applicable HUD handbook requirements when it processed and approved the loan for the construction of the new facility housing the Loganhurst Health Care center in Spokane, Washington.

Specifically we found that HUD did not:

- Adequately consider the principal owner's poor financial and business history;

- Require the mortgagor sponsor to submit complete financial statements for the corporation;

- Return the application to the mortgagee for failure to adequately pre-screen the application; and

- Require a written explanation of the derogatory information.

Although Loganhurst's owner, J.A.M. Davis, and its representative, Hoover Mortgage, did not fully disclose the financial condition of the project as required, sufficient disclosures of past and potential financial difficulties were made in the mortgage application documents that should have caused the Seattle Office of Housing to reject insurance endorsement for the loan.

The former Seattle Multifamily Housing Director approved a risky and financially weak applicant, and the owner subsequently diverted over $177,000 in project operating funds to pay back loans and other non-project costs that were incurred in order to obtain approval for the loan. These diversions further weakened the owner's financial position, and the property soon went into default and foreclosure. The owner also violated HUD requirements by making a prohibited asset transfer.

The Seattle Multifamily Hub appears to have implemented adequate controls that should prevent a reoccurrence of the problems discussed in this memorandum. As such, this memorandum does not include any recommendations.

HUD requirements for mortgage insurance for residential care facilities

According to paragraph 1-4 of HUD Handbook 4600.1, *Residential Care Facilities – Nursing Homes*, the Field Office Manager is responsible for assuring that underwriting is carried out in accordance with the program regulations and instructions. Paragraph 2-4 requires that, in order to be eligible for this FHA program, all mortgagors must be single asset mortgagors.

Paragraph 4-5 requires the mortgagor to submit complete financial statements including an Aging Schedule of Accounts Receivable and Payable that provides: name, type of account (trade, affiliate, employee, relative or other), payment terms, amount and aging information. In addition, all financial statements submitted for an application must include the criminal certification on the back of Form HUD-92417.

HUD Handbook 4470.1 *Mortgage Credit Analysis*, Paragraph 2-2 requires mortgagees to pre-screen the proposed applications for completeness and verify the information presented in the application against information contained in the applicant's credit report(s) and financial statements. They are required to closely review the credit reports and financial statements and:

- Make reasonable inquiries to determine if the mortgagor has undisclosed Federal debt;
- Determine if potential discrepancies between the financial statements and credit reports exist; and
- Determine if there is any adverse information such as slow payments or potential judgments.

Chapter 2 of Handbook 4470.1 also establishes HUD's underwriting responsibilities. HUD Mortgage Credit staff must:

- Decide whether the application and exhibits are acceptable for processing;
- Review the application exhibits as listed in Handbook 4600.1;
- Send the Multifamily Housing Representative (MHR) a listing of any missing credit information or ask for supplemental or clarifying information needed to prepare the case for processing;
- Return the application if the mortgagee fails to pre-screen the application;
- Reject applications that include missing or incomplete exhibits;
- Assure that credit reports obtained by HUD or the mortgagee provide all of the required information;
- Investigate any adverse credit information that appears on the credit report or which becomes known;
- Require a written explanation of derogatory information; and
- Reject the application based on the credit analysis if the principal has a history of slow payments, unresolved Federal debt or if there are judgments or actions against the party, which could significantly impact upon the financial position of the individual/firm or result in a determination that the individual/firm is an unacceptable credit risk.

Paragraph 3-6 provides guidance on the analysis of the applicant's financial statements and instructs the Mortgage Credit staff not to consider interlocking investments between affiliated corporations, and to consider only assets that are readily available for investment by the mortgagor.

At Initial Endorsement HUD requires the mortgagor representative to sign a Regulatory Agreement (HUD-92466 (10-85)). It states "Owners shall not without the prior approval of the Secretary:…

> c. Assign, transfer, dispose of or encumber any personal property of the project, or including rents,
>
> e. Make, or receive and retain, any distribution of assets or any income of any kind of the project, except surplus cash…."

<u>The principal owner's poor financial and business history was not adequately considered</u>

Information submitted by Hoover Mortgage on behalf of Loganhurst Health Care and the principal owner disclosed a history of slow payments, including late payment of Federal employment taxes. Further, the principal owner's credit report disclosed a history of slow payments of creditors. She also filed personal and business bankruptcies in 1990 due to bad decisions made while administering the nursing home. Our analysis of her financial position at the time of loan application revealed that she did not have capacity to service her existing debt.

The Section 232 mortgage insurance program is unique among HUD's multifamily insurance programs because the insurance covers buildings used as nursing homes. Loganhurst was the first Section 232 project processed by the Seattle Office of Housing. On the surface, J.A.M. Davis met the Section 232 requirements as it was structured as a single asset (the nursing home building) entity with the minimum required capitalization. The building was designed only as a nursing home facility and could not generate revenues to pay the mortgage if it did not contain a well-run nursing home business. During the application process for the Loganhurst loan, the Office of Housing did not sufficiently review the underlying business that was supposed to support the payments on the insured 232 mortgages, its past performance, and the financial history of its principal owner. Instead the Office of Housing only considered the building and the building's ownership entity when underwriting the insured loan.

The mortgagor sponsor did not submit complete financial statements

Hoover Mortgage did not present complete financial statements for the Loganhurst loan. The financial statements for Loganhurst and its principal owner did not contain the following required exhibits:

- Criminal certifications from both Loganhurst and the principal owner.
- A complete listing of real property owned by the principal owner, including original cost and assessed value. A listing of real property that contained all of the required elements would have disclosed an overstatement in the value of the old nursing home building.
- Supporting schedules for receivables and payables for Loganhurst's financial statements. Our review of the Loganhurst financial statements indicated that there were excessive balances in the Accounts Receivable, Accounts Payable, Payroll Taxes, and Benefits Payable accounts. Supporting schedules may have disclosed items such as doubtful receivables, slow payments of creditors and delinquent Federal tax payments.

The Seattle Office of Housing should have required the mortgagor sponsor to submit all required financial statement documents.

The application should have been returned to the mortgagee's representative for failure to adequately pre-screen the application

The application package submitted by Hoover Mortgage on behalf of J.A.M. Davis was not adequately pre-screened. HUD requires that applications must be pre-screened and, if the application package is not complete, it should be returned to the mortgagee's representative.

An adequate pre-screening would have revealed the following:

- The principal owner's financial statement overstated the asset valuation. The old nursing home building and land value were significantly overstated. Our review of a prior financial submission disclosed that the tax-assessed value was approximately $200,000; however, the principal owner's financial statement valued the land and building at over $1.2 Million. Furthermore, a financial statement submitted in an earlier application package valued the old building at over $500,000 less.

- There were over $600,000 of related party transactions in the principal owner's financial statements that should not have been considered during the financial statement screening and analysis. The $600,000 asset had no solid financial basis as it consisted primarily of the principal owner's own valuation of her holdings of J.A.M. Davis stock. Excluding this self-valued asset, the principal owner's financial statement would show a negative net worth, and insufficient income to pay her existing debt.

- Loganhurst's financial statements were inconsistent with its credit report. According to the credit report, Loganhurst is a cash basis business with no trade accounts, however our review of the financial statements disclosed significant balances in accounts payable.

The application did not have a written explanation of all the derogatory information

In an August 1996 pre-application questionnaire, the principal owner disclosed that the project had received $350,000 of interim financing from the United Security Bank (USB); however, the application did not include any mention of this financing. In an internal email, a member of the HUD mortgage credit staff questioned why the $350,000 loan was not shown in the application. The HUD underwriting files had no other documentation relating to this loan until the May 2, 1997 application supplement from J.A.M. Davis, which showed the USB loan amount as $579,807, almost $230,000 more than the amount shown in the pre-application questionnaire. Subsequently, HUD received a copy of a letter dated May 5, 1997 from Loganhurst's project manager to Hoover Mortgage explaining that the USB loan was a personal debt of the principal owner, and that J.A.M. Davis, Inc. "…is not involved in this transaction in any way." However, according to a United Commercial Code (UCC) Security Filing, still in effect at the time of the May 5, 1997 letter, USB had a security interest in J.A.M. Davis' business assets and accounts, indicating that J.A.M. Davis (not Florence Reynolds) was the actual borrower.

The May 5, 1997 letter also stated that none of the new HUD-insured loan proceeds would be used to repay the USB loan. In June 1997, the owners of J.A.M. Davis and the Vice President of United Security Bank signed a restructure agreement removing J.A.M. Davis from liability on the note subject to the conditions in the restructure agreement. However the restructure agreement contained the following clause:

> "That Reynolds, and Guarantors, as principals of J.A.M. Davis hereby covenant that they shall cause J.A.M. Davis to perform all obligations required by J.A.M. Davis under all agreements between USB and J.A.M. Davis, contemporaneously engaged in and executed with the aforementioned Promissory Note. Included therewith is an Agreement which sets forth the mechanics of the establishment of a $150,000 Capital CD, an Architectural Fee CD, and provides that J.A.M. Davis shall receive reimbursement, on ultimate HUD approval, for certain development fees. All parties covenant that they shall cause J.A.M. Davis to assign to USB all rights to receive fee reimbursements as contemplated in said Agreement. J.A.M.

> Davis hereby agrees to continue to be bound by the provisions of said Agreement."

In effect, the above clause provides that reimbursements received by J.A.M. Davis from the HUD loan proceeds will be used to pay off the USB loan. Hoover Mortgage's files contained a copy of the USB loan restructure agreement but failed to forward a copy to HUD. If it had been provided, HUD would have been aware that the May 5, 1997 letter to Hoover was in conflict with the June USB loan restructure agreement and that J.A.M. Davis continued to be obligated to pay off the USB debt.

HUD concentrated its underwriting review on the ownership entity and did not follow up on information pertaining to the project's principal owner. There was no documentation in the underwriting files that HUD did any further research on this loan transfer or questioned where the principal owner would obtain the funds to pay off this debt. At a minimum, HUD should have requested and reviewed a copy of the agreement to restructure the loan between USB, J.A.M. Davis, and the Davis family to determine who was actually responsible for the loan repayment.

The owner made improper diversions and a prohibited asset transfer after loan endorsement

The owner violated the regulatory agreement by using over $177,708 of Loganhurst Health Care operating funds to pay back loans covering project cost overruns and other costs associated with the old nursing home building. The regulatory agreement specifies that rents can only be used for operating expenses unless the business is in a surplus cash position. Our review of the project's accounting records disclosed that over $52,743 of stockholder loans were paid off from 1999 to 2001. In addition, payments of over $94,515 were made on the USB loan. We also found that over $30,450 was used for costs associated with the Turner Mansion building. According to the project's accounting records, no surplus cash was available when these payments were made.

The owner also violated HUD's eligibility requirements by transferring title of the Turner Mansion to J.A.M. Davis. Legal records disclosed that a quitclaim deed was recorded on October 7, 1998 and listed J.A.M. Davis Inc. as the legal owner of the land and building (Turner Mansion) located at 1521 E. Illinois. The transfer occurred after initial endorsement and prior to final endorsement of the FHA mortgage and is in violation of eligibility requirements. During the application process Loganhurst acknowledged that they were aware of the single asset, single mortgage requirement.

This report focuses on HUD's underwriting processes. The OIG is separately addressing issues regarding the loan sponsor's role in the application process, and the owner's Regulatory Agreement violations.

HUD indicates it has procedures to reduce underwriting risks

Northwest/Alaska Multifamily Hub officials generally agree with our finding. In their written response (Appendix A), they said that, subsequent to the approval of the Loganhurst loan, and prior to our audit, new Department-wide policies and procedures were put into place that reduce the underwriting risk of Section 232 Health Care Facilities. According to the HUB, all submissions for FHA Section 232 insurance to the Northwest/Alaska Hub are processed under Multifamily Accelerated Processing (MAP). They also noted that the HUB developed additional monitoring procedures to further scrutinize the underwriting of Section 232 facilities by the MAP-approved lenders.

The current underwriting procedures include:

- Prohibiting MAP lenders to process loans if they have a history of loan assignments due to poor underwriting;
- Approval of MAP lenders by HUD Headquarters using strict guidelines;
- Periodic monitoring and on-site reviews of MAP lenders by the Office of Quality Assurance;
- Prohibition against waiving the submission of required MAP documents;
- Prohibiting the participation in the Section 232 loan program of any owner or operator of a healthcare facility or their affiliates that has filed for, is in, or has emerged from bankruptcy within the prior five years;
- Assignment of three Senior Project Managers from the Northwest/Alaska Multifamily Hub to participate in all underwriting reviews of health care facilities. This monitoring includes close collaboration with state health care licensing staff to determine if there are any issues that may negatively impact the health care facility's license to operate.
- Under MAP, underwriting team members review the entire loan application and not just sections of the application package pertaining to a team member's particular discipline.

The response also noted that the Northwest/Alaska Hub took immediate steps when it learned of the owner's violations of the Regulatory Agreement including:

- Sending a letter to J.A.M. Davis requesting corrective action;
- Recommending foreclosure immediately after the facility closed; and
- Flagging all J.A.M. Davis' principals and Hoover Mortgage in HUD's 2530 computer system. Doing so prevents J.A.M. Davis, its principals, and Hoover Mortgage from participating in FHA multifamily insurance programs.

<u>HUD's controls appear to be adequate</u>

We agree that the Northwest/Alaska Hub's current underwriting procedures, if followed, should prevent a reoccurrence of the issues discussed in this report. Further, the Hub's current internal procedures, including interfacing with state health licensing officials and reviews of the entire underwriting package by all members of its underwriting team, should alert the Hub to financial weaknesses and inconsistencies in loan applications.

U.S. Department of Housing and Urban Development
Office of Multifamily Housing
Northwest/Alaska Multifamily HUB

Northwest/Alaska

RECEIVED
JUN 19 2002
HUD/OIG AUDIT
SEATTLE, WA

June 18, 2002

MEMORANDUM FOR: Frank E. Baca, District Inspector General for Audit, OAGA

FROM: Renee D. Greenman, Director, Northwest Alaska Multifamily Hub, 0AH

SUBJECT: Draft Audit Memorandum
Loganhurst Health Care Facility
Spokane, Washington

This is in response to your draft audit report on "Review of the underwriting and administration of the insured mortgage for a Section 232 Project, J.A.M. Davis Incorporated, dba Loganhurst Health Care, Spokane, Washington". The Inspector General's Office review resulted in one finding and suggested the combination of poor underwriting by HUD and financial irresponsibility of the project's owner led to the owner's bankruptcy and the default and subsequent foreclosure of the insured mortgage.

The Northwest Alaska Multifamily Hub submitted a Request for Audit on May 30, 2001, because we had reason to believe there were diversion of funds and unauthorized distribution of project revenues. The audit immediately commenced because the facility was closed by the State. It is our understanding a separate report will be issued which addresses our request for audit.

Following is a discussion of policies and procedures that are in place by the NW AK Multifamily Hub, which reduce the underwriting risk of Section 232 Health Care Facilities. It should be noted that these policies and procedures were in place prior to the beginning of the audit.

Subsequent to the time period Loganhurst Health Care Facility was underwritten for mortgage insurance, the Department has implemented Multifamily Accelerated Processing (MAP). All Section 232 Health Care submissions for FHA mortgage insurance in the Northwest/Alaska Hub are processed under MAP. TAP processing is not economically acceptable due to the time consuming HUD contracting process. Also, the Northwest/Alaska Multifamily Hub developed additional monitoring procedures to further scrutinize underwriting of Section 232 Health Care facilities. Following is a discussion of these procedures implemented by Northwest/Alaska Multifamily Hub:

1. Qualification standards for a MAP lender include rejection of the lender to do MAP business if lender has a recent history of assignments of FHA-insured loans if it is determined that the lender had been at fault in the loan underwriting. (MAP GUIDEBOOK...Chapter 2 Section 2.3.G)

Suite 190 • Seattle Federal Office Building • 909 First Avenue • Seattle, WA 98104-1000
http://www.hud.gov/local/sea/mfh/seamfhpg.html

2. Qualification standards for a MAP lender include rejection of the lender to do MAP business if responses to the Office of Quality Assurance from Multifamily Hubs and Program Centers regarding the lender's previous work showed a pattern of unsatisfactory applications for mortgage insurance. (MAP GUIDEBOOK...Ch. 2 Section 2.3.H)

3. All Section 232 underwriters are now specifically approved and reviewed in Headquarters, which requires a stricter level of expertise and experience.

4. MAP lender agrees to make files available to HUD for monitoring of MAP processed loans. Origination files are to be maintained for 10 years. . (MAP GUIDEBOOK...Ch. 2 Section 2.8)

5. MAP lenders are subject to monitoring and periodic on-site reviews by the Office of Quality Assurance to verify that MAP loans in processing by the lender or HUD endorsed MAP loans were underwritten according to statutory, regulatory and MAP Guide requirements. . (MAP GUIDEBOOK...Ch. 2 Section 2.9.A)

6. The Qualifications and Monitoring Division of the Office of Multifamily Development in Headquarters must approve MAP lender-underwriters for Section 232 loans. (HUD Notice H 01-03 paragraph II)

7. Since the inception of MAP Headquarters has provided ongoing support to the field to tighten up current underwriting procedures. Each of the HUD underwriting disciplines in the field now has a contact in Headquarters to whom they can seek guidance for underwriting decisions. Moreover, Headquarters now has a Section 232 consultant HUD field underwriters can correspond with to help make underwriting decisions, locate current health care research and personal repository of national health care underwriting information.

8. Under MAP, exhibits listed for MAP applications cannot be waived. For instance, business entities must submit balance sheets, income and expense statement and supporting schedules for the last 3 years. This reference can be found at paragraph 8.4.B.2.

9. MAP underwriters must certify that they have completed their review of the application in accordance to the MAP Guidebook. Mandated in this review is an analysis of the financial statements of the nursing home business to evaluate the historic and ongoing operating history of the facility

10. 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. (HUD Notice H 01-03 paragraph III)

11. All Northwest/Alaska Multifamily Hub underwriting teams are directed to correspond with State Health Care licensing officials in the state in which the proposed health care facility is or will be located to determine the state's current and past experience with the health care facility's ownership entity, management company, and Administrators' qualifications and licensing requirements.

    For established projects which are being refinanced, sub-rehabbed or replaced in our underwriting we required the appraisers to check the website for current state rating of the operation. If the rating is below average the lender will be required to provide additional information to the underwriting team for further review of the HUD underwriter.

12. All Northwest/Alaska Multifamily Hub underwriting teams are directed to carry out Post-Endorsement Monitoring reviews on 25 percent of the prior year's Final Endorsed insured loans. The 25 percent are selected on a risk-based process and Section 232's are at the top of the list. The Post Endorsement Protocol and Post Endorsement Review Checklist are attached. In addition to the Post Endorsement Reviews, we also assess and monitor rent-up information on projects to use in future underwriting of new construction, sub-rehabilitation and replacement of older facilities. The information is shared in spreadsheet form with HUD appraisers and economists.

13. Pre-occupancy conferences for all insured health care facilities are required by the Northwest/Alaska Hub to be held by Senior Project Managers when a project reaches 60 percent completion for new construction. For refinances and purchases of the health care facilities pre-occupancy conferences are to be held at Final Closing. In the case of Loganhurst, a preoccupancy conference was held on November 24, 1998, with the Administrator and Project Manager who were duly informed about Regulatory Agreement requirements, owner distributions, and provided with copies of the applicable HUD handbooks, notices, and circular letters. The project representatives were fully informed about all HUD requirements and cautioned about unauthorized distribution of project revenues at that time. The project representatives (Florence Reynolds and Ray Carter) acknowledged this meeting by signing a copy of the "Pre-Occupancy Conference Checklist" (attached).

14. Three Senior Project Managers from the Northwest/Alaska Multifamily Hub Asset Management Team have been assigned to participate in all underwriting reviews of health care facilities, as well as to monitor the financial operations of all facilities from initial endorsement through final payoff of the loan. Asset Management monitoring activities include close collaboration with state health care licensing staff to share information, early on, of any situations which might negatively impact a HUD insured facility's license. In the case of Loganhurst, the property was reassigned to a Senior Project Manager in March 2001. This staff person immediately took aggressive action to identify Regulatory Agreement violations and sent a certified letter to the President of JAM Davis, Inc., dated April 9, 2001, requesting corrective action. The facility was subsequently closed by the State of Washington the later part of May 2001 and the field office immediately recommended foreclosure to HUD's Property Disposition Center. On

July 11, 2001, guidance was issued to all staff in the Northwest Alaska Multifamily Hub regarding review of Section 232 loans, especially during the first year of operation. A copy of the Monitoring Protocol is attached.

15. Under MAP each of the underwriting team members are requested to review the total application package not just sections of the package pertaining to a team member's particular discipline. Because of this policy, other members of the team pick up red flags that may have been missed by the specific technician in their review.

In view of the policies, procedures, and program requirements discussed above, we do not feel any recommendations need to be implemented which address any corrective action with respect to underwriting by HUD Multifamily Mortgage Credit staff. We have flagged all project principals in the 2530 System including Hoover Mortgage. We would support an OIG referral to the U. S. Attorney on project principals for providing and falsifying certifications to HUD prior to Final Endorsement as well as for violations of the Regulatory Agreement. In addition, we would support a referral to the Mortgagee Review Board on Hoover Mortgage Company.

Attachments:

Section 232 Monitoring Protocol
Pre-Occupancy Conference Checklist
Post Endorsement Protocol

Philip Head

07/11/01 05:41 PM

To: NW-AK MF Hub
cc:
Subject: Project Manager Guidance for Review of 232's especially during first year of operation.

Staff,
The following guidance has been reviewed by both program center directors and is now effectively implemented for the Hub. This information will also be posted on our Intranet/Hubweb site.

Philip

MF Project Managers:

We are beginning to see evidence that our 232 Assisted living and Nursing Home portfolio is showing signs of financial stress. During the past six months we have had five mortgage assignments including Loganhurst ([redacted]), Serendipity (207/223 (f)), and the three Health Resources Inc., (formerly coinsured), 207/ 223(f) properties. The evidence points to problems such as overly optimistic business plans, diversion of funds, cash flow problems, poor operating efficiencies, lack of high quality oversight by administrators, loss of and pressure by shrinking State Medicaid funding levels, and slow Medicaid reimbursement policies. The impacts of this can have a devastating effect on the financial health of a property to the point of forcing owners into defaulting on the mortgage payment.

Moreover, we know Medicaid/Medicare payments from the State are usually received toward the end of the month. This can require owners to juggle funds to meet the monthly mortgage payment. If the problems are systemic and cash flow problems are not corrected, ultimately the financial pressure will limit the owner's ability to meet the monthly mortgage payment. Late mortgage payments result in late fees which put additional financial hardship on the owner, and can also trigger mortgage delinquency notification from the lenders. If the cycle of these stresses isn't corrected it doesn't take too long before the owner's property is in trouble. Nursing Homes present an even more complex situation because we have insured a business as opposed to apartment rental units.

We are making good progress with the State DSHS for HUD staff to get information on performance records of Nursing Home owners and operators. Moreover, Project Managers are now able to access published reports that help to identify operational problems and will list findings and deficiencies observed. All of these tools will help us to recognize the early warning signs of a faltering or potentially failing facility, and make it imperative that we become more interactive with our DSHS partners in the State.

We must be alert to performance indicators and undertake a much wider approach toward understanding and monitoring the financial health of both our the new and exising underwritten loans. When project indicators show a property is moving from a fully performing postion to a troubled or failing status we must be more aggressive in our approach. We must first determine what the underlying cause is and move to take the appropriate corrective action. In some cases that may involve an enforcement action, change of management, or even a change of ownership. In other cases a plan of action that will cure a systemic problem may be appropriate, provided the owner is cooperative and recognizes that changes must be made. To re-energize our review and monitoring process, the following Project Management servicing guidance points are listed on the back page .

Project Managers should also review and provide feedback to the Asset Development team on first year underwritten loans. and especially be sure to discuss issues involving faltering, financially stressed, or troubled properties. The bottom line is that PM's must actively monitor their assigned portfolios, proactively follow up with plans that address the root problems, and use the results of these hard lessons to avoid repeating the same mistakes in the future.

R.L. Stettner, Director

MONITORING GUIDANCE

Existing Assigned Inventory:

- Monthly accounting reports (see handbook 4370.1 chapter 3). It is critical that these reports are received and reviewed from initial occupancy for at least six months even if sustaining occupancy is reached prior to the that time or until such time that you are satisfied that the property is fully performing. Also, reports must be received and reviewed on all troubled properties. The emphasis here is not just on reviewing reports, but ensuring that all new projects are actually providing them. Missing accounting reports are cause for concern!
- Contacts with counterparts in the State, DSHS Departments
- Meet with facilities administrators
- Review annual audited financial statements and check for compliance issues as well as performance flags. Also, we need to check for diversion of funds .
- Check REAC physical inspection scores. Low scores may indicate underlying financial problems.

PM's to provide Asset Development team Supervisors with the following feedback 6 months after initial occupancy and in the case of sub rehab 6 months after the rehab start date:

New Construction: Section, 221(d) , 232

- Monthly lease-up (occupancy levels)
- Monthly expenses
- Any rent concessions made during rent up
- Confirmation of licensing
- Provide any feedback or comments from state regulators regarding project, i.e. check Medicaid website to see how many findings DSHS may have listed on their last survey. If it is substantially above the State average, determine why and if corrective action has been taken, [redacted] only.

Sub-Rehab:Sectiion 221 (d), 232

- Monthly census during Rehab
- Rent concessions
- Monthly expenses after Rehab
- Any negative comments from state regulators regarding project, [redacted] only.

Refinance or Purchase: 223 (f), 232/223 (f)

- Monthly census
- Rent concessions
- Monthly expenses
- Any negative comments from state regulators regarding project, [redacted] only.

With the Above information our development staff will be able to test assumptions made during their underwriting analysis:

1. Rent up assumed when estimating operating deficit
2. Expense break out when estimating operating deficit
3. Proforma estimates used in the 92264 analysis

~0053254.ckl | Page 1

PRE-OCCUPANCY CONFERENCE CHECKLIST
(NON-SUBSIDIZED)

COPY

Project Name and Number Loganhurst 171-43034

Mortgagor JAM Davis Inc dba

Mortgagee PFC

Management Agent Mortgagor

TOPIC/REQUIREMENTS:

- [✓] Regulatory Agreement (form HUD-92466)
- [✓] Owner Distributions & Surplus Cash
- [✓] Replacement Reserves (R/R)
- [✓] Leasing/~~Occupancy~~
- [✓] Maintenance of mortgaged premises, accommodations, and grounds
- [✓] Payment for services, supplies, or materials
- [✓] Identity-of-Interest
- [✓] Annual Financial Statements
- [✓] Monthly Accounting Reports (Forms HUD-93479, HUD-93480, & HUD-93481)
- [✓] Books and records
- [ ] N/A Insurance and Loss Drafts
- [✓] Fidelity Bond Coverage
- [✓] Tenant Security Deposits
- [ ] N/A Tenant/Landlord Smoke Alarm Certification
- [ ] N/A Lead-Based Paint: Notification of Tenants (if applicable)
- [✓] Management Certification
- [ ] N/A Management Agreement
- [✓] Mortgagee Annual Physical Inspection
- [✓] HUD Physical Inspections & Management Reviews
- [✓] Affirmative Fair Housing Marketing Plan (form HUD-935.2)
- [✓] Change in Ownership: Transfer of Physical Assets (TPA)

[✓] Fair Housing and Equal Opportunity (FHEO)

[✓] Partial Release of Security; Alterations, Modifications, or Additions to Physical Structures

[✓] Prepayment

HANDBOOKS, NOTICES, CIRCULAR LETTERS, ETC. (copy provided):

[✓] HUD Handbook 4350.1: Insured Project Servicing

[✓] HUD Handbook 4370.2: Financial Operations and Accounting Procedures for Insured Multifamily Projects

[✓] HUD Handbook 4381.5: Management Documents, Agents and Fees

[✓] HUD Handbook 2000.04 : Consolidated Audit Guide for Audits for HUD Programs

[✓] Notice H 93-29: Lead-Based Paint: Notification of Tenants in HUD-insured, HUD-held and HUD-subsidized Housing

[✓] Circular Letter 10HMLM 91-09: Policy For Procurement and Payment of Services, Supplies, and Materials (Including Exterior Painting)

[✓] Form HUD-928.1: Affirmative Fair Housing Poster

MISCELLANEOUS INFORMATION:

[✓] HUD Asset Manager (Name, Address, Telephone, FAX):

Byron Nellis, Appraiser
920 W Riverside Suite 588
Spokane Wa. 99201
(509) 353-0670 EX 3028
FAX (509) 353-0677

[✓] Discrimination Complaints:

Information: 1-800-669-9777
Hearing Impaired (TDD): 1-800-800-5029

[✓] Forms and Issuances: (206) 220-5140

[✓] Handbooks & Notices: 1-800-767-7468

This certifies the above checked items have been discussed, reviewed and/or provided:

ATTENDANCE LIST:

~0053254.ckl Page 3

(Signature)	(Title)	(Date)
[illegible]	Sec / Admin	11/24/98
Ray E. Carter CPA	Project Mgr	11/24/98

1

D. R. A. F. T.

MAP POST ENDORSEMENT REVIEW AND LENDER MONITORING PROCEDURES

I. Introduction

HUD started implementation of Multifamily Accelerated Processing (or, MAP) for underwriting FHA insured applications throughout the Multifamily Hub or Program Centers in the summer of year 2000. MAP requires Lenders TO BE skilled in underwriting multifamily housing loans and in the preparation of an application for FHA multifamily mortgage insurance. MAP Guide Chapter 2 specifically states that the MAP Lenders are subject to monitoring and periodic on-site reviews by Office of Quality Assurance (or, OQA) to verify for MAP HUD committed loans in processing by the Lender or HUD endorsed. A approved MAP Lender must agree that its files and records available to HUD or HUD's authorized contractors for monitoring of MAP processed loans. The origination files should be maintained for 10 years by the Lender. Currently, the OQA has not outlined the specific monitoring functions or responsibilities for the Hubs and the Program Centers. The Northwest/Alaska Multifamily Hub is implementing local MAP Post Endorsement Review Procedures as part of management control process to reduce underwriting risks of loans submitted and underwritten by the Lender under Multifamily Accelerated Processing (MAP). MAP relies heavily on the participating lenders to perform many of the underwriting functions previously performed by HUD staff. We felt it was important to develop an interim directive for monitoring and quality assurance control of the MAP lenders in order to evaluate the efficiency and effectiveness of MAP processing. The MAP Post Endorsement Review Procedures described in this directive will be used in the Northwest/Alaska Hub jurisdiction only and will be re-evaluated on an annual basis.

This directive outlines the responsibilities of the Local Office of Multifamily Housing, the Operations Branch, and the OQA in monitoring MAP lenders. The Northwest/Alaska Multifamily Hub will review and evaluate the procedures and may revise this directive for lender monitoring on an annual basis.

II. Origination & Servicing Lender's Submission and Information

A. Project Information - through Final Endorsement

Remote monitoring will be based on documentation contained in project dockets, including underwriting and other project information at initial and final endorsement.

B. Project Information - After Final Endorsement

Project management and servicing data must be submitted in accordance with the requirements in Handbook 4530.1 Rev.2.

III. **Local Office of Multifamily Housing (or, Local office) Responsibilities**

A. **Pipeline Reviews.**

Local office is responsible for monitoring each lender's progress toward underwriting through closing on projects for which a Firm Commitment Letter has been issued.

1. Local office will survey the lenders to determine the number of projects in their current pipeline and the estimated date of submission to HUD for review and endorsement. The survey must also include an estimate of the number of units and mortgage amount.
2. Local office will enter in DAP system the project status.

B. **Remote Monitoring.**

Local office will also remotely perform the post-endorsement compliance reviews and reviews of lender servicing. Each year the Seattle Hub and the Program Centers will conduct **risk analysis** of lenders of record that have at least one case endorsed in the NW/A Multifamily Hub jurisdiction for the past fiscal year to determine which lenders will be considered for monitoring on an annual basis. A lender review schedule will be developed to lay out our monitoring plan. Patterns detected by Local office that must be avoided or corrected by the Mortgagee in future processing must be brought to the attention of the lender in writing. Failure to make modifications or agree to take corrective actions, or to accomplish such modifications or corrective actions, within a time period specified by Local office, may be basis for termination of the lender's participation in MAP or sanctions against the lender.

1. Sources. Remote monitoring by Local office will consist of reviewing:
   a) project underwriting information files provided by the lender;
   b) project management and servicing information after the project reaches the management stage;
   c) other information contained in the closing docket relative to compliance with underwriting standards and procedures.

2. Number of Projects/Files to be Reviewed. Not all projects/files need be reviewed for each lender selected for monitoring. **All Northwest/Alaska Multifamily Hub underwriting teams are directed to carry out Post-Endorsement Monitoring reviews on 25 percent of the prior year's Final Endorsed insured loans. The 25 percent are selected on a risk-based process.**

3. Contents of Reviews:

a. Project Data Files - Development.
Local office will review the project data submitted by the lender to determine whether the lender's underwriting assumptions and conclusions are reasonable. This review will include loan-to-value ratios, debt service coverage ratios, financing costs and similar data elements.

b. Management Servicing and Disposition.
Local office is responsible for monitoring all management, servicing and disposition activities of the lender to ascertain that the lender complies with the procedures and requirements approved by HUD. The lender must submit copies of the annual physical inspection reports and for projects not in safe and sanitary condition, summaries of actions required, with target dates, to resolve the issues.

C. **Referral to Office of Quality Assurance for On-site Monitoring**
Local office will refer cases through the Multifamily Hub to the OQA for further on-site reviews. The basis for these reviews will be the trends determined through remote monitoring and elements that do not lend themselves to remote reviews. The following covers the areas that may be suggested by Local office for on-site monitoring by the OQA:

1. Development Responsibilities.
The review of lender's activities from origination through closing are subject to monitoring, including but not limited to:

a. review of lender's compliance with HUD procedures for project underwriting;
b. review of the adequacy of the lender's submission of project information to the EMAS;
c. review of the lender's project records for compliance with any special environmental conditions required by the Environmental Engineer following the environmental review.
d. review the lender's procedures and implementation of the quality control plan of monitoring the performance of any outside third party contractors;
e. verification that appraisals are performed by Certified General Appraisers, licensed in the State in which the property is located, and that all appraisal functions are completed in accordance with the Uniform Standards of Professional Appraisal Practice; and
f. verification that loan origination records are properly maintained and that loan underwriting decisions are made by personnel trained

2.13 Effect of Probation and Termination

A. Probation

1. As noted in the previous section of this chapter, the Hub Director or the Director of OQA may place a Lender's MAP designation in a probationary status. Probation is limited by time or conditioned upon the Lender meeting a specific requirement or requirements, such as replacement of a staff member, or both. When the specific requirement or requirements are met to the satisfaction of the Director placing the Lender on probation, the probation period may be ended and the Lender may resume its activities and responsibilities as a MAP Lender.

2. During the period that a MAP Lender is on probation, it may not submit materials for new pre-application reviews or new applications for Firm Commitments for FHA multifamily mortgage insurance under MAP. It may, however, continue to process applications which were initiated by the submission of exhibits to a HUD processing office prior to the probation date.

3. Probation shall last until the problems justifying probation are corrected to the satisfaction of the Hub Director, or, if probation has been imposed by the Director of OQA, to the satisfaction of the Director of OQA.

4. Probation initiated by a Hub Director is limited to the Lender's activities in the geographical area of the Hub and its Program offices. Probation initiated by the OQA Director shall be on a national basis unless the OQA Director determines that probation should apply only in a geographically restricted area. Notice of probation, whether limited to a geographical area or national, shall be posted on the web. When probation is lifted, that information shall also be posted promptly on the web.

B. Termination

1. As noted earlier in this chapter, either the Hub Director or the Director of OQA may make a recommendation to the MAP Review Panel for termination of a Lender's MAP approval. The Hub Director's recommendation for termination is forwarded to the OQA Director for review and forwarding to the MAP Review Panel. When the Review Panel makes a decision for termination effective on a specific date, the MAP Lender may not initiate any new applications for FHA multifamily mortgage insurance under MAP, including exhibits for a pre-application review. Any pending applications which are being processed at the time of termination may no longer be processed under MAP. The Lender will either have to transfer the application for processing to another MAP Lender or continue with the application using traditional HUD processing. If traditional processing is used, the Hub or Program Center may require that the process start from the beginning.

2. An application for reinstatement of MAP authority may not be made until at least 12 months after the date of termination. The requirements for reinstatement shall be similar to initial qualification, discussed in Sections 2.3 and 2.6 of this chapter, and the applicant must show that the problems which led to termination have been resolved to the satisfaction of OQA.

2.14 Appeals

A. When a MAP Lender has been placed in a probationary status, it may appeal this decision to the Deputy Assistant Secretary for Multifamily Housing. When a MAP Lender's approval has been terminated by the MAP Review Panel, the decision of the Panel may be appealed to the Deputy Assistant Secretary for Multifamily Housing. The request for the appeal must be made within 30 calendar days of the date the Lender was either placed in probation or the effective date for termination as determined by the MAP Review Panel.

B. If the decision is appealed, the Hub Director, OQA Director, or MAP Review Panel will present to the Deputy Assistant Secretary for Multifamily Housing the evidence on which the Director or Panel made its decision, and the Lender may present such relevant evidence as it wishes. The presentation of evidence and any other relevant information shall be submitted with 30 days of the Lender's request for review. The Deputy Assistant Secretary will make his or her decision within 30 days after receiving the evidence from the Panel or the Director.

C. If the Deputy Assistant Secretary for Multifamily Housing reverses the Panel's or Director's decision, the Lender shall immediately return to an active status as a MAP Lender. The active status of the MAP Lender will be posted on the HUD web.

2.15 Referral to the Mortgagee Review Board or the Inspector General

If the OQA or the Hub Director determines that a MAP Lender's actions or failure to act appears to be a compliance matter justifying action by the Mortgagee Review Board to penalize the Lender, including possible removal of its authority to do business as an FHA Lender, a referral of the matter should be made to the Mortgagee Review Board. If the issue involves possible fraud, misrepresentation or other criminal violations, then the matter should be referred to the Office of Inspector General.

DISTRIBUTION OUTSIDE OF HUD

Ranking Member, Committee on Governmental Affairs, 340 Dirksen Senate Office Building, United States Senate, Washington, DC 20510
Chairman, Committee on Government Affairs, 706 Hart Senate Office Building, United States Senate, Washington, DC 20510
Chairman, Committee on Government Reform, 2185 Rayburn Building, House of Representatives, Washington, DC 20515
Ranking Member, Committee on Government Reform, 2204 Rayburn Building, House of Representatives, Washington, DC 20515
Director, Housing and Telecommunications Issues, United States General Accounting Office, 441 G Street, NW, Room 2T23, Washington, DC 20548
Chief, Housing Branch, Office of Management and Budget, 725 17th Street, NW, Room 9226, New Executive Office Building, Washington, DC 20503
Senior Advisor, Subcommittee on Criminal Justice, Drug Policy and Human Resources, B373 Rayburn House Office Building, Washington, DC 20515
House Committee on Financial Services, 2129 Rayburn House Office Building, Washington, DC 20515
Senior Counsel, Committee on Financial Services, U.S. House of Representatives, B303 Rayburn House Office Building, Washington, DC 20515