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TO: Frederick Tombar (Acting), Deputy Assistant Secretary for Multifamily Housing, HT

Roger E. Niesen

FROM: Roger E. Niesen, Regional Inspector General for Audit, 7AGA

SUBJECT: Nationwide Survey of HUD's Office of Housing Section 232 Nursing Home program

INTRODUCTION

We have completed a survey of the Office of Housing's administration of HUD's Section 232 Nursing Home program. We initiated the survey based on previous OIG audits of insured nursing homes that identified numerous violations of HUD's regulatory agreements. Our objective was to determine if HUD had adequate controls in place to identify and correct significant regulatory agreement violations. Although HUD's internal program data did contain evidence of regulatory agreement violations, we found HUD does not have adequate controls in place to ensure all violations are identified. However, HUD is in the process of taking action to address the control weaknesses. The implementation of actions to correct the control weaknesses should help ensure the nursing home program is effectively managed.

During our survey, we conducted interviews with appropriate headquarters and field staff in both the Office of Housing and the Real Estate Assessment Center. In addition, we reviewed:

- HUD's policies, regulations and handbooks to evaluate controls relating to nursing homes.
- HUD and OIG websites for past issues identified in audits performed by OIG that related to our survey objective.
- E-mails we received from OIG headquarters and District Offices of Audit and Investigations relating to present and past audit and investigative activities
- Office of Housing's Financial Assessment Subsystem (FASS) and analyzed the database for information on monitoring activity and examples of regulatory agreement violations. We reviewed the system to determine if evidence of regulatory violations existed within the FASS database files. We did not evaluate HUD's controls over the FASS system or the integrity of the data contained in the system.

Our survey period was October 1, 1998 through September 30, 2001. However this period was expanded where necessary to include more current data. Except for the FASS system limitations discussed above, this survey complied with generally accepted government auditing standards.

In accordance with HUD Handbook 2000.06 REV-3, within 60 days please give us, for each recommendation without management decisions, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after report issuance for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of the audit.

Should you or your staff have any questions, please contact me at (913) 551-5870.

SUMMARY

HUD does not have adequate controls in place to ensure all nursing home regulatory agreement violations are identified. We identified significant control weaknesses that occurred because past management did not properly assess and identify risks or design and implement proper controls to protect HUD's interests in its nursing home portfolio. HUD's internal program data contains evidence of regulatory agreement violations; however, HUD does not have adequate controls in place to ensure all violations are identified. In addition, the nursing home annual audited financial statements submitted to the Real Estate Assessment Center's (REAC) Financial Assessment Subsystem (FASS) contain numerous examples of regulatory agreement violations; however, the system does not include audited financial statements for leased nursing homes. We believe that these significant control weaknesses have contributed to a high number of defaults and assignments of Section 232 projects.

The Office of Housing has initiated actions to identify and correct program control weaknesses. Housing has identified weaknesses in the Section 232 program and has begun considering appropriate corrective actions. However, Housing does not have a timetable for implementing the proposed corrective actions.

We commend Housing's staff for their efforts in identifying significant control weaknesses and developing corrective measures. Housing's list of issues relating to the Section 232 program (Appendix A) addresses all of the control weaknesses we identified during our audit survey, plus some additional weaknesses.

BACKGROUND

Congress established HUD's section 232 nursing home program in 1969. HUD's Office of Multifamily Housing administers the program. Generally, the program's purpose is to insure mortgages made by private lending institutions. These mortgages are used to finance construction or renovation of nursing homes, and assisted living and rest homes for the elderly.

Specifically, Congress established the program to:

- Conserve and increase the supply of nursing homes, intermediate care facilities, board and care homes.
- Provide credit enhancement through insurance of mortgages for new or substantially rehabilitated projects.
- Purchase or refinance existing Section 232 insured projects with or without repair.

The nursing home program is unique because in many instances there can be as many as five parties involved in the arrangement as follows:

- 1) HUD.
- 2) The Mortgagee.
- 3) The Mortgagor/Owner of the property.
- 4) The Lessee.
- 5) The Operating Entity.

In addition, the Owner, Manager and Operating Entity often form an Identity of Interest relationship.

HUD has experienced an increasing high number of defaults and assignments in nursing homes insured under the Section 232 program. During the period August 30, 1999 through September 30, 2001, mortgages for 64 projects containing 6,925 units totaling \$276,689,364 were assigned to HUD.

FINDING

Housing Does Not Have Adequate Controls to Effectively Manage The Nursing Home Program

HUD does not have adequate controls in place to ensure all nursing home regulatory agreement violations are identified. We identified significant control weaknesses that occurred because past management did not properly assess and identify risks or design and implement proper controls to protect HUD's interests in its nursing home portfolio. HUD's internal program data contains evidence of regulatory agreement violations; however, HUD does not have adequate controls in place to ensure all violations are identified. In addition, the nursing home annual audited financial statements submitted to the Real Estate Assessment Center's (REAC) Financial Assessment Subsystem (FASS) contain numerous examples of regulatory agreement violations; however, the system does not include audited financial statements for leased nursing homes. We believe that these significant control weaknesses have contributed to a high number of defaults and assignments of Section 232 projects.

Office of Management and Budget Circular A-123, Management Accountability and Control, provides the specific requirements for developing and implementing appropriate cost-effective management controls for results-oriented management and for assessing the adequacy of controls

in place. The Circular guidance requires agency managers to continuously monitor the effectiveness of management controls associated with their programs. Management has primary responsibility for monitoring and assessing controls, and should use other sources as a supplement to its own judgment. Among the sources of information to be utilized by management are program evaluations conducted on a regular basis. In addition, the agency managers are responsible for taking timely and effective action to correct deficiencies identified by the variety of assessment and monitoring tools available to management. Correcting deficiencies is an integral part of management accountability and must be considered a priority by an agency.

From our review of past OIG audit reports and the Real Estate Assessment Center's Financial Assessment Subsystem (FASS) we identified the following significant control weaknesses:

- HUD does not have a Handbook(s) specific to the Section 232 Nursing Home operations that ensures all nursing homes follow the regulatory agreement and applicable state and Federal requirements.
- Project managers do not have sufficient training on reviewing nursing homes and dealing with the unique issues that arise with Section 232 properties.
- The regulatory agreement (HUD Form 92466) used on owner-managed nursing homes is not specific to Section 232 nursing homes. The agreement does not incorporate the requirements that the property must comply with all state and Federal medicare/medicaid guidelines and provide proof of compliance to HUD. Lacking these provisions in the regulatory agreement, the state could pull the operator's license and close the facility without HUD's knowledge.
- The regulatory agreement used on nursing homes operating under a lease arrangement (HUD Form 92466-NHL) lacks the requirements contained in Section 6(a) thru (f) of HUD Form 92466 used for owner-managed nursing homes. The missing requirements prohibit certain actions unless prior written approval of the Secretary of HUD has been obtained. The absence of these requirements jeopardizes the viability of the property and creates an inability on the part of HUD to control activities of the lessee, and establishes an unacceptable risk to the mortgage insurance fund.
- The security agreement language used in the Uniform Commercial Code and other security instruments is too broad to ensure that all the assets of a property are covered by the mortgage.
- The Certificate of Need may not transfer in some states. The lessee may hold the Certificate of Need and the operating license and could take it with them if they terminate the lease. Without both documents the property is not viable and its value would be significantly reduced should HUD have to acquire it.
- The Real Estate Assessment Center's Financial Assessment Subsystem (FASS) does not include all Section 232 nursing homes. Lessees are not required to submit annual financial statements to HUD through the Financial Assessment Subsystem. As a result, HUD is not

able to utilize the financial and compliance checks contained in the system to identify and follow up on deficiencies.

Because of the above control weaknesses, HUD does not have assurance that nursing homes are being operated effectively and in accordance with HUD's requirements and the regulatory agreement. We believe weak controls have contributed to a high number of defaults and assignments. Assignments totaled \$276,689,463 over a two-year period ending September 30, 2001. The assignments affected 64 projects containing 6,925 units.

During our survey we learned the Office of Housing had established a task force to address control weaknesses. Successful implementation of the task force recommendations should correct the problems we identified. The control weaknesses and problems identified by Housing include the weaknesses we identified in our audit survey in addition to several others. The weaknesses identified by the task force are as follows (see Appendix A for a detailed presentation:

- No Handbook for Nursing Home/Assisted Living Facility servicing requirements.
- Regulatory Agreement does not include specific requirements for Section 232 properties.
- Financial Assessment Subsystem does not allow the owner and lessee to submit annual financial statements electronically. Thus, the financial and compliance checks contained in the system are not utilized.
- Potential problems are associated with non-recourse mortgages. The regulatory agreement and the underwriting process needs to be strengthened in relation to Section 232 properties if the mortgages remain non-recourse to the owner to avoid a potential increase in the default rate.
- Housing needs improved monitoring and legal tools to provide early indication of possible default.
- Housing staff needs additional training on servicing of Nursing Homes and Assisted Living Facilities.
- HUD needs to strengthen the underwriting process for Section 232 properties. Also HUD needs complete market study and background check of prospective program participants as part of the process.
- Certificate of Need may not transfer in some states when there is a sale or refinancing. The lessee may hold the Certificate of Need and license, and may want to take it with them if they terminate their lease. Therefore, the project could not operate without the Certificate of Need and license.

- Receivables need to be included in the uniform commercial code documents and other security instruments to strengthen HUD’s control over assets of the property in case of regulatory agreement violations.
- Procedures are not consistent between Field Offices using different addendums for mortgage, regulatory agreements, and security agreements.

The Office of Housing has taken steps to develop an action plan to address the weaknesses they identified in the Section 232 program (see Appendix A). However, the corrective actions do not currently include a timetable for implementation. We believe the sooner the corrective actions are implemented by the Office of Housing, the quicker the level of defaults and assignments will begin to decrease. The timely implementation of corrective actions will serve to better protect HUD’s mortgage insurance fund from future losses.

AUDITEE COMMENTS

Following is a complete text of the Acting Deputy Assistant Secretary for Multifamily Housing Programs comments other than those of an editorial nature:

“We appreciate the opportunity to comment on the Draft Survey of Nursing Homes. We also appreciate the report’s acknowledgement and commendation of our efforts to identify and correct program control weaknesses.”

“We agree with the audit’s findings and recommendation and will provide specific time frames for implementation of the working groups recommendations, and monitor the accomplishment of those activities. To establish time frames, we will need to discuss the changes with the working group and with the Office of General Counsel (OGC) on the changes to the Regulatory Agreement. While a new Regulatory Agreement has been drafted it is not yet in clearance; however, we will work with OGC to expedite the clearance. When we get the time frames established, we will also add the tasks to our tracking of significant activities.”

“Again, thank you for the opportunity to comment. If you have any questions please call me at (202) 708-2495.”

OIG EVALUATION OF AUDITEE COMMENTS

Auditee comments agree with our finding and recommendation.

RECOMMENDATION

We recommend that the (Acting) Deputy Assistant Secretary for Multifamily Housing:

- 1A. Establish specific time frames for implementing corrective actions for each of the weaknesses identified by the Section 232 task force and monitor the actions to ensure timely and effective completion.

MANAGEMENT CONTROLS

Management controls include the plan of organization, methods and procedures adopted by management to ensure that its goals are met. Management controls include the processes for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

We determined that the following management controls were relevant to our survey objectives and considered them to the extent necessary to gain an understanding of the control environment:

- Controls over monitoring of nursing home operations to determine compliance with applicable guidance.
- Controls over identifying and correcting significant regulatory agreement violations within the Section 232 program.

It is a significant weakness if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet an organization's objectives.

Based on our survey, as presented in the finding, we believe the following issues represent significant weaknesses in HUD's control environment:

- HUD has not developed a Handbook that is specific to Section 232 Nursing Homes.
- HUD has not properly trained project managers on how to manage nursing homes.
- HUD has not developed a regulatory agreement that is specific to owner managed nursing homes.
- HUD has not developed an adequate regulatory agreement that addresses lessee-managed nursing homes.
- HUD's interests are not adequately protected by legal documents such as the Security Agreement, Certificate of Need and Uniform Commercial Code.
- HUD has not required lessee-managed nursing homes to submit Audited Financial Statements to the Financial Assessment Sub System for review.

FOLLOW-UP ON PRIOR AUDITS

This is the first nationwide review of the Office of Housing's controls over HUD's the Section 232 program.

MULTIFAMILY ASSET MANAGEMENT

Working Group

232's

Issues	Practice/Policy	Recommendation/Options	New Orleans Flipchart
1 No Handbook for Nursing Home/Assisted Living servicing requirements	NH's are currently not covered in AM Handbooks	Add a Chapter to the Servicing Handbook to cover monitoring requirements for 232's. This should include the review of monthly accounting reports for new nursing homes until we are assured they are performing fully. Guidance should also include contacts with State, checking state websites to determine compliance, meeting with facilities administrators, reviewing AFS's, reviewing REAC inspections, and providing development feedback (see 7/11/01 memo from Cameron Eldredge and R.L. Stettner). Chapter should include that HUD must approve a 2530 for the Administrator and/or managing agent, and/or lessee, and obtain a copy of the lease, and/or Management Agreement (if applicable).	Add a servicing chapter in 4350.1 handbook dealing with Nursing Homes. (or 4600 serving chapter). The group preferred the 4350.1 chapter.
2 Regulatory Agreement doesn't include specific requirements for 232's.		Revise Regulatory Agreement (RA) for owners and lessee's to include that the project must meet all state requirements for operation and that if the state or HHS issues a notice of violation or default, the owner or lessee must notify HUD of the violation. Include a requirement that the owner and/or lessee must provide HUD a copy of the results of their annual licensing inspection. Also add that a fidelity bond must cover employees handling funds. For Lessee RA's, include any and all future lessees must execute a RA, and add Section 6(a) through (c), 6(e) through (g), 8, and all provisions of 9 from HUD-92466. In addition to using revised RA's for all new loans, if possible, require existing RA's to be amended.	Federal Medicare/Medicaid rules -state rules - vary for each state. -Contracting out? Business Agreements
3 FASS system doesn't allow owner and lessee to submit AFS.		Change FASS system. Until change is completed, require hard copy from lessee and require the owner to electronically submit.	
4 Recourse vs. non-recourse		Leave as non-recourse to encourage FHA – insured financing, but strengthen	Use MAP.

	mortgages		underwriting and Regulatory Agreement.	
5	Need tools to provide early indication of possible default.		Obtain performance indicators for NH's from FASS/NASS, State Agencies, and/or Health Care Consultants. Obtain notices of State/HHS violations from operator and results of annual licensing inspections.	
6	Need additional training on servicing of NH's and ALF's.		Provide satellite broadcast training for all PM's to discuss review of AFS's and other servicing requirements. Have one person per HUB specialize in 232's that receives additional on-site training (possibly from Jack Payne). Training should include information on Medicare and Medicaid requirements and income.	Need a Task Force – Development Management OGC HQ & Field with industry
7	Strengthen underwriting for 232's.	HUD Handbook 4600.1 REV-1, Section 9-1 A requires CON or alternative market study. MAP Guide requires CON and market study with comparables. 4600.1 and MAP requires state reports on facilities operations for refi's.	Train EMAS person to know NH/ALF markets. Contact State to determine their experience with participants. Have HQ staff available for consultation on NH/ALF applications. Ensure market study required is provided and is complete. Complete prudent underwriting for 232's. Option: If market study is deficient, require analysis by independent health care consultants of market info (provided by lender). Analysis by health care consultant for feasibility of marginal deals.	-State must participate -financial activities of operator -physical condition -review of business agreements -recourse financing -revise both Reg agreements -provide state reports annually -market analysis -marketing -operating deficits -CON/license stay with facility -monitoring -TPAs
8	Certificate of Need may not transfer in some states when there is a sale or refinancing. Lessee may hold CON, and may want to take it with them if they terminate their lease.	4600.1 REV-1, Section 2-2, 3. and 4. states CON must be pledged as security and may not be transferred. License and provider agreement must also stay with project.	CON and license should always be required to stay with project as the Handbook requires.	
9	Asset Management wants receivables included in the UCC's and other security instruments, but some financiers do not.		Include receivables in UCC and other security instruments. Add to language of Section 9 (h)(3) in owners Regulatory Agreement that the Owners shall execute a Security Agreement and Financing Statement upon all items of equipment and receivables. Also add this language to the additions to lessee's RA.	
10	Inconsistencies between Field Offices using addendums for		All Field Offices use the addendums implemented in Ohio until the legal documents are revised. Until the RA's	

Mortgage, Regulatory Agreements, and Security Agreement. 11 Competition in the market place causing older 232's to lose residents.	are revised, the Ohio addendums for RA's should be revised to add the language recommended in Issue 2. Facility may need to improve its marketing plan (use consultants) to stabilize the occupancy. Meet with lender and owner to discuss option of having a renowned management company, familiar with that type of facility, to take over the management. For ALF's, PM could contact the ALFA State Chapter to obtain a list of regional or national management companies that specialize in marketing and operating small ALFs.
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