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|---|
| November 21, 1996 |
| Audit Case Number |
| 97-BO-111-0001 |

TO: Nichols P. Retsinas, Assistant Secretary for Housing - Federal Housing Commissioner, H

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Section 232 Nursing Home Program
Review of Underwriting Procedures

We performed a review of the Section 232 Nursing Home program. Our overall objective was to determine whether the Department's nursing home underwriting procedures are sound and provide adequate protection to prevent over insuring or insuring faulty loans. Our review focused on recently refinanced substantially rehabilitated nursing homes.

The Department's underwriting procedures are generally sound. However, we found inconsistencies in the way the HUD State Offices treat income from leased operations during the construction phase. These inconsistencies can result in overinsuring HUD mortgages which unnecessarily increases HUD's risk.

Please furnish us copies of any correspondence or directives issued related to this audit.

We want to thank you and your staff for the courtesy showed to us during the audit. Should your staff have any questions, please contact our office at (617) 565-5259.

# Executive Summary

The primary purpose of our review of the Section 232 Nursing Home program was to determine whether HUD's underwriting procedures were sound and provided adequate protection to prevent over insuring or insuring faulty loans.

HUD's underwriting procedures are generally adequate. Review of financial data for substantially rehabilitation nursing homes which were finally endorsed in the New England area that they are generally financially stable. We found certain inconsistencies by seven HUD State Offices reviewed in the way they handled income during the construction period.

Four State Offices considered only lease income during the construction period in determining the maximum insurable mortgage when there were executed leases.

Two State Offices considered income based on both Mortgagor/Owner and Operating Entity operations in determining the maximum insurable mortgage.

One State Office recognized operating nursing home projects as New Construction; therefore, income during the construction period is not considered at all.

Our results were provided to the Director, Office of Multifamily Housing Development during our audit. On June 24, 1996, your staff advised that the Department is aware of problems associated with unclear instructions and the outdated HUD forms, and it was the intention of your Office to issue a notice clarifying several critical points regarding the underwriting, processing, and mortgagor requirements under the Section 232 program.

A draft copy of the Notice was provided to OIG for review and comment on November 5, as amended on November 19, 1996. The purpose of the Notice was to address issues regarding production, definition, licensing, underwriting, marketing and monitoring projects insured under the Section 232 program. The latest draft amendment of the Notice covered the items disclosed by our review. Accordingly, we are not making any recommendations in this report.

# Table of Contents

# Abbreviations

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|---|---|
| HUD | U.S. Department of Housing and Urban Development |
| OIG | Office of Inspector General |
| IOI | Identity of Interest |
| FHA | Federal Housing Administration |

# Introduction

The Section 232 Nursing Home program, established by Congress in 1969, is administered by the Office of Multifamily Housing program within HUD's Office of Housing. The nature of the program is to insure mortgages made by private lending institutions to finance the construction or renovation of nursing homes, assisted living and rest homes for the elderly. As of October 1988, projects already insured by HUD were also eligible for purchase or refinancing with or without repairs under Section 232.

The Section 232 Nursing Home program is unique among HUD's mortgage insurance programs. In most of HUD's mortgage insurance programs there are 3 parties involved in the arrangement; HUD, the Mortgagee, and the Mortgagor/Owner of the property. The Section 232 Nursing Home program, in many instances, has 4 parties involved in the arrangement; HUD, the Mortgagee, the Mortgagor/Owner of the property, and an Operating Entity. The Operating Entity "operates" the nursing facility and holds the license, while the Mortgagor/Owner owns the property. Although the Mortgagor/Owner and Operating Entity are different entities, many times there is an Identity of Interest (IOI) relationship.

HUD has insured over 1,900 nursing home facility mortgages around the country since the inception of the program in 1969. HUD uses geographical designations to manage it's Section 232 Nursing Home program (Appendix A). As of April 17, 1996, HUD's nursing home facility portfolio included 715 active mortgages at final endorsement (Appendix B) representing over $2.9 billion in mortgage insurance (Appendix C). In addition, there are 185 nursing home facilities at the initial endorsement stage and 220 nursing home facilities in the process of reaching initial endorsement (Appendix D). These nursing home facilities could reached final endorsement within the next year and would represent an additional $3.2 billion in mortgage insurance (Appendix E).

One hundred fifty-six mortgages, approximately 12% of the total number of Section 232 mortgages, that reached final endorsement, have been assigned to HUD since the inception of the program. As of April 17, 1996 there were only 91 Section 232 mortgages that were HUD held.

HUD's portfolio of nursing home facilities represent a small percentage when compared to the total nursing home facility universe. A 1994 study estimated the total number of nursing home facilities in the United States to be 17,513. HUD's nursing home facility portfolio of mortgages finally endorsed represents 4% of the total nursing facilities in the United States. In recent years, the rate of HUD insured nursing home facilities reaching final endorsement has increased (Appendix F). With medical technology enabling people to live longer and an aging baby boomer generation, it can be anticipated that these numbers will continue their upward trend.

**Audit objective**

The purpose of our review of the Section 232 Nursing Home program was to determine whether HUD's underwriting procedures are sound and provide adequate protection to prevent over insuring or insuring faulty loans.

**Scope and methodology**

Our review generally covered the period from January 1, 1990 to April 17, 1996. We performed our review from May 1995 until July 1996. Our audit work was performed at the following HUD State Offices: Connecticut; Massachusetts; Rhode Island; New Hampshire; New York; Ohio; and North Carolina. We also selected a sample of nursing facilities for review in the above State Offices.

We identified the total universe of nursing home facilities insured under Section 232 of the National Housing Act since the inception of the program in 1969. We also obtained information on the total universe of nursing home facilities, FHA and non-FHA, nationwide.

As part of our review, we interviewed the Directors of Multifamily Housing Divisions for HUD offices that had significant Section 232 activity. The purpose of the interviews was to determine the procedures used in the different HUD offices, regarding the use of income earned during the construction/rehabilitation stage, in determining the maximum insurable mortgage. We also obtained information pertaining to leasing arrangements surrounding nursing home facilities.

During our review, we discussed the different characteristics, features, and problems associated with the Section 232 Nursing Home program with Asset Management and Production staff in selected field offices. We also talked with Headquarters staff from the Office of Deputy Assistant Secretary for Multifamily Housing programs, Office of Multifamily Housing Development, and the Office of Mortgage Insurance and Accounting Servicing.

We focused our review primarily on nursing home facility mortgages processed by the New England State Offices. We selected for review projects which had a Mortgagor/Owner and Operating Entity IOI relationship, which recently under went substantial rehabilitation, and had reached the cost certification stage. We reviewed cost certification documents, financial statements, leasing arrangements, and general mortgaging servicing file documents to determine if all income generated during the construction/ rehabilitation stage, not just income earned as a result of leases, was used to reduce the final construction costs.

Our review included determining whether nursing homes were profitable by reviewing: nursing home financial statements for selected nursing projects in New England and Ervin and Associate's (HUD's Asset Management contractor) summaries of financial position for nursing home facilities.

We performed our review in accordance with generally accepted auditing standards.

# Results of Audit

HUD's nursing home underwriting procedures are generally sound and provide adequate protection to prevent overinsuring or insuring faulty loans. Our review of nursing homes underwritten in New England showed a low default rate and that the projects were generally profitable.

We also found that the management arrangements for nursing homes often employ identity of interest leasing arrangements. Unless the HUD processing office is fully aware of these arrangements, proper safeguards to protect HUD's interests may not exist. We found that the leasing arrangements can be manipulated to the benefit of the project owner, which can result in HUD overinsuring the mortgage. Our review showed that there were inconsistencies in the ways various HUD Offices processed these cases. These inconsistencies resulted mainly from a lack of clear internal processing instructions.

Our meetings with your staff and discussions of these inconsistencies and the need for clarifying instructions occurred several times during the audit. As a result, your staff is in the process of issuing clarifying instructions which when implemented should strengthen HUD's processing, provide better protection for HUD's interests, and lessen the possibility of overinsuring mortgages.

Details of our results follow.

Inconsistent accounting for income

HUD offices used different procedures to account for income earned during the construction/rehabilitation stage. Existing nursing home projects being rehabilitated can generate substantial income because operations continued yet all debt service is capitalized. Income generated during the construction/rehabilitation period is to be used to reduce construction costs which may result in reducing the maximum insurable mortgage. Inconsistencies were disclosed in the identification of income during the construction period and how the income was applied.

Only lease income was considered

Considering only lease income and not total operating income resulted in possible overinsured mortgages for five of eight projects reviewed. The other three projects did not result in overinsured mortgages.

| Project Number | Operating Income Not Recognized |
|---|---|
| 017-43053 | $647,647 [1] |
| 017-43060 | $314,000 [1] |
| 043-43085 | $212,213 |
| 043-43089 | $901,981 |
| 053-43096 | $ 19,085 |

[1] State Office is currently re-evaluating their initial mortgage determinations.

This occurred in four State Offices: Hartford, CT; New York, NY; Greensboro, NC; and Columbus, OH.

Total operating income was considered

Review of the three nursing homes, located in two State Offices: (Hartford, Connecticut and Boston, Massachusetts) disclosed that total operating income, not just the lease income, was recognized: Project Nos. 017-43068; 023-43157; and 023-43147.

No income was considered

The New York State Office advised that they processed substantially rehabilitated nursing homes as new construction and therefore did not recognized any type of income.

Proposed clarifications

The proposed Notice that your office plans on issuing clarifies the income issue in determining the amount and type of income that should be recognized during the period up to cost certification cut-off. The proposed Notice provides that:

*"Total income, including lease payments, must be recognized during the construction/rehabilitation period. When an identify-of-interest lease situation exists, S/AOs must take exception to artificially low-lease payments (less than typically charged in the market), which will permit the mortgagor to avoid a mortgage reduction.*

*At the time of cost certification, an audited operating statement . . . to the cost certification cut-off date, must be submitted by:*

1. *The mortgagor entity, in all cases.*

*2. Lease Arrangements*

*a. The lessee, when an identity-of-interest exists between the mortgagor and lessee and the lessee has executed the Regulatory Agreement-Nursing Home, Form HUD-92466 NHL). While a review of both the mortgagor's and lessee's statements is required in determining the actual amount of net income available to off-set allowed costs, primary emphasis is given to the lessee's statement. Review of the statements in accordance with the instructions in Chapter 11 of Handbook 4470.1 REV-2. In addition, when reviewing the lessee's statement:*

*1) increase net income by the amount of the lease payment paid to the mortgagor (lease expense).*

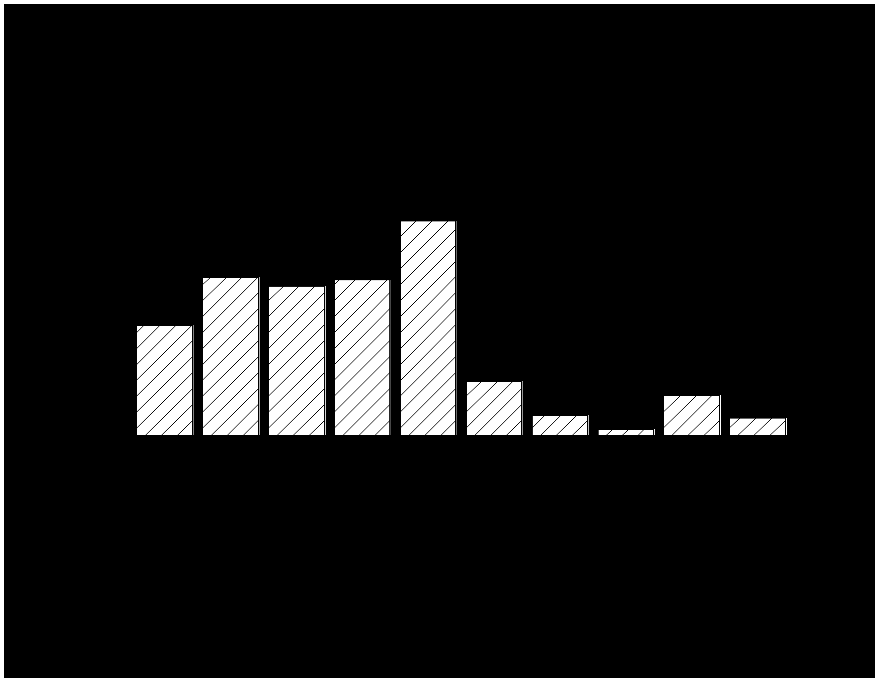
*2) increase net income by any income, other than lease income, reported on the mortgagor's income statement.*

*3) decrease net income to include typical project operating expenses from the mortgagor's statement, which the mortgagor is required to pay per the lease agreement, i.e., real estate taxes, insurance, etc. Make sure there is no duplication of expenses. . . . ."*

These instructions, when implemented, should alert HUD Processors to the need for careful review of leasing arrangements. We believe these changes will improve the chances that HUD will not over-insure mortgages. Accordingly, no further recommendations are needed.

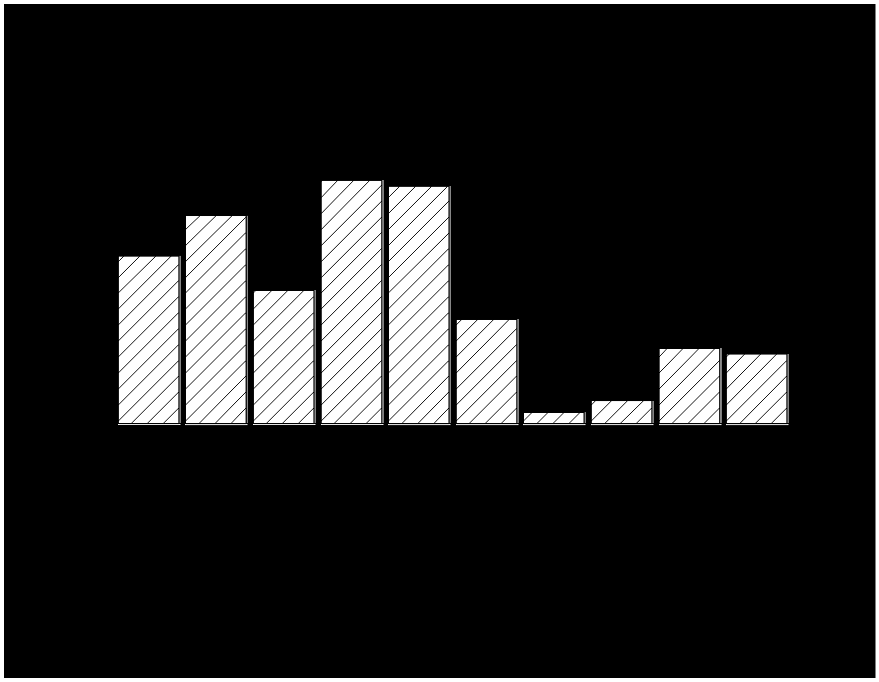
# Map of HUD's Geographic Designations

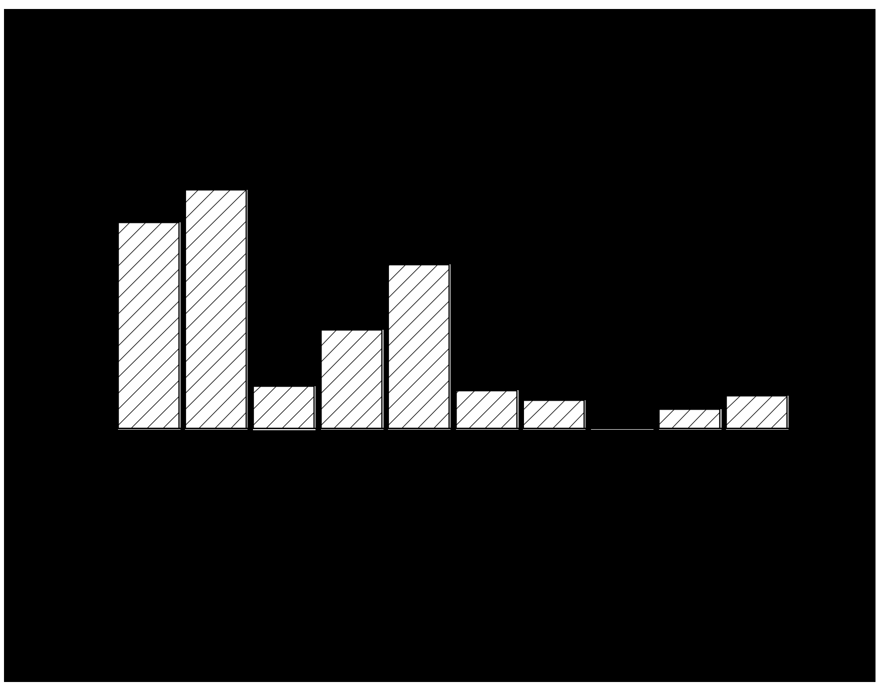
# Mortgage Insurance Activity Since Inception - 1,880



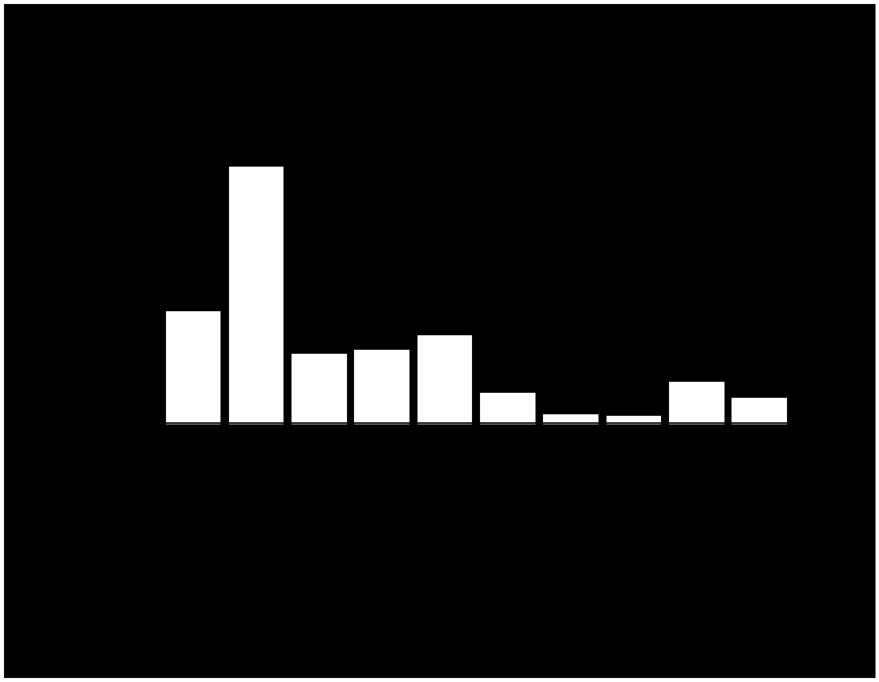
# Outstanding Finally Endorsed Mortgage Amounts - $2.9 Billion

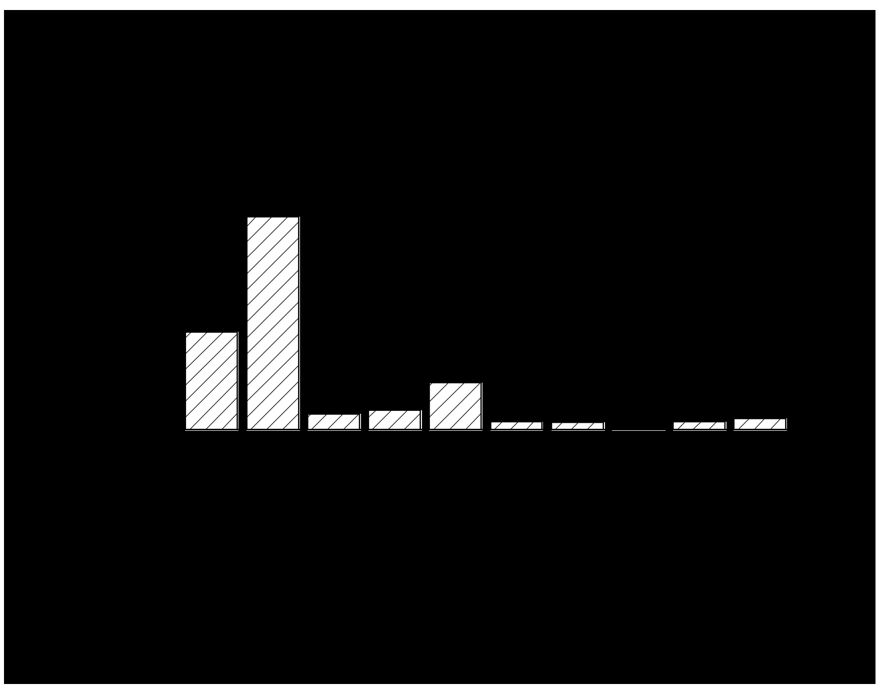
# Number Of Mortgages In Process - 405



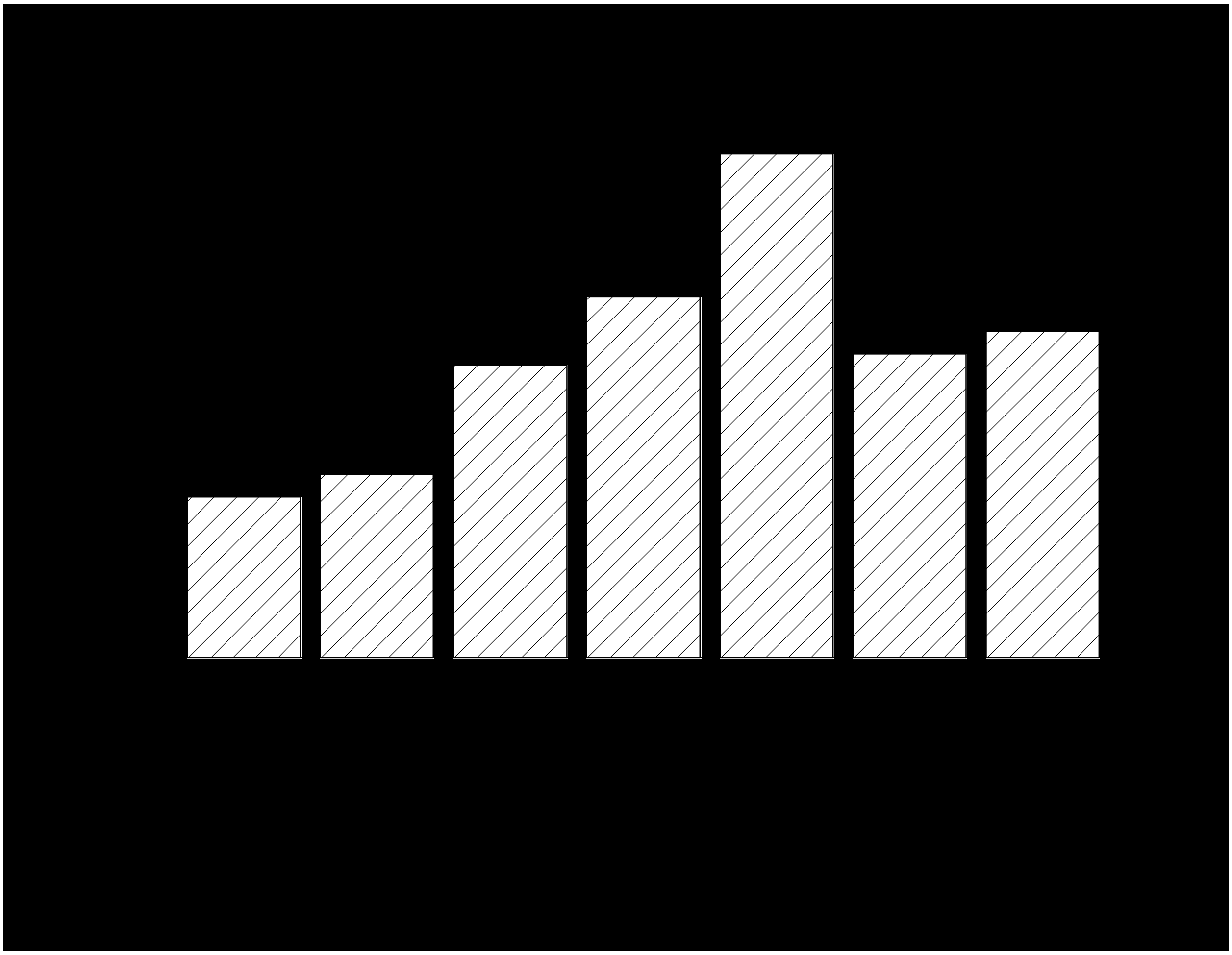


# Value of Mortgages In Process - $3.2 Billion





# Mortgages Reaching Final Endorsement in Recent Years



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