Office of Healthcare Programs

Washington, DC

HUD's Approval of Section 232 FHA-Insured Loans

Office of Audit, Region 3
Philadelphia, PA

Audit Report Number: 2018-PH-0001
August 10, 2018

To: Roger M. Lukoff, Deputy Assistant Secretary, Office of Healthcare Programs, HP

//signed//

From: David E. Kasperowicz, Regional Inspector General for Audit, Philadelphia Region, 3AGA

Subject: HUD's Office of Healthcare Programs Generally Approved Section 232 FHA-Insured Loans in Accordance With HUD Requirements

Attached is the U.S. Department of Housing and Urban Development (HUD), Office of Inspector General's (OIG) final results of our review of HUD's approval of Section 232 Federal Housing Administration (FHA)-insured loans.

HUD Handbook 2000.06, REV-4, sets specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the audit.

The Inspector General Act, Title 5 United States Code, section 8M, requires that OIG post its publicly available reports on the OIG website. Accordingly, this report will be posted at http://www.hudoig.gov.

If you have any questions or comments about this report, please do not hesitate to call me at 215-430-6734.

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HUD's Office of Healthcare Programs Generally Approved Section 232 FHA-Insured Loans in Accordance With HUD Requirements

Highlights

What We Audited and Why

We audited the U.S. Department of Housing and Urban Development's (HUD) approval of Section 232 Federal Housing Administration (FHA)-insured loans based on our initiative to focus HUD management's attention on problem areas with the Section 232 program. Our audit objective was to determine whether HUD approved Section 232 FHA-insured loans for projects that qualified for mortgage insurance in accordance with HUD requirements.

What We Found

HUD generally approved Section 232 FHA-insured loans for projects that qualified for mortgage insurance in accordance with HUD requirements. For the three loan files reviewed, valued at nearly $50 million, HUD maintained documentation to show that it adequately reviewed (1) loan applications for program eligibility; (2) financial operations of the operator; (3) the creditworthiness of the borrower, operator, and operator parent; (4) professional liability insurance; and (5) the project capital needs assessment. However, it did not adequately evaluate the creditworthiness of the management agents as required. This condition occurred because HUD's underwriters did not follow procedures. As a result, if HUD does not implement controls and procedures to ensure that it properly evaluates the creditworthiness of management agents, it could approve loans for projects with management agents that significantly impact the financial position of the project.

What We Recommend

We recommended that HUD develop and implement controls and procedures to ensure that its underwriters properly evaluate the creditworthiness of management agents when underwriting future loans. It took immediate corrective action during the audit to implement the recommendation.

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Background and Objective

In 1959, under Section 232 of the National Housing Act, Congress established the U.S. Department of Housing and Urban Development's (HUD) Section 232 program. The Section 232 program is a Federal Housing Administration (FHA) mortgage insurance program that insures HUD-approved lenders against financial loss from mortgage defaults. HUD's Office of Residential Care Facilities (ORCF), within HUD's Office of Healthcare Programs, administers the program. Section 232 loans help finance nursing homes, assisted living facilities, and board and care facilities. Proposed projects are evaluated based on whether the proposal is an acceptable insurance risk for the FHA insurance fund. Section 232 loans may be used to finance the purchase, refinance, new construction, or substantial rehabilitation of a project. The program contains the following seven types of loans.

Loan type	Loan description
1. Section 232 new construction	This is a loan in which all project and construction elements are installed as part of the construction contract and no work has been done before the issuance of the HUD firm commitment.[1]
2. Section 232 substantial rehabilitation	This is a loan for projects undergoing substantial repairs or improvements.
3. Section 232-223(f) purchase or refinance	This is a loan for projects that do not meet the requirements for substantial rehabilitation but are eligible for refinance or purchase under this section. Existing FHA-insured loans may refinance under section 223(f).
4. Section 232-223(a)(7) refinance	This is a streamline refinanced loan for an existing FHA-insured loan.
5. Section 232-241(a) supplemental loans	This is a loan for existing FHA-insured loans to complete additions, repairs, replacements, energy conservation measures, improvements, or combinations of these items. The purpose of these loans is to provide financing to keep the property competitive, extend its economic life, and provide for replacement of obsolescent equipment.
6. Section 223(d) operating loss loan	This is a supplemental loan that provides owners of FHA-insured projects a vehicle for recouping their out-of-pocket expenditures to fund unforeseen operating deficits during the early years of the project's operation.
7. Section 232(i) fire safety equipment loan	This is a loan for financing the purchase and installation of fire safety equipment, primarily fire sprinkler systems.

[1] HUD's agreement to provide mortgage insurance on loans under the provisions of section 232

Loan applications are completed by borrowers and reviewed and submitted by a HUD preapproved lender. After the lender submits the application package to HUD, an ORCF underwriter reviews the application, exhibits, and the lender's conclusions. The ORCF underwriter uses a punch list,[2] which contains the following nine areas, to review the application:

1. general underwriting and program eligibility;
2. financial operations and appraisal review;
3. creditworthiness of the borrower;
4. creditworthiness of the operator;
5. creditworthiness of the operator parent;
6. creditworthiness of the management agent;
7. professional liability insurance, State surveys, and risk management programs;
8. project capital needs assessment review (physical condition); and
9. preparation for loan committee and firm commitment.

After the ORCF underwriter reviews the documentation and the lender's recommendation, the underwriter presents the results of his or her review to a loan committee. The loan committee reviews the application and the underwriter's recommendations and either approves or rejects it. If the loan committee approves the application, a firm commitment will be issued. If the loan committee rejects the application, a rejection letter will be issued.

As of October 2017, HUD's Section 232 portfolio included 4,086 active loans, valued at more than $28.5 billion, with unpaid principal balances totaling more than $26.1 billion.

Our objective was to determine whether HUD approved Section 232 FHA-insured loans for projects that qualified for mortgage insurance in accordance with HUD requirements.

[2] A punch list is an internal HUD document containing review steps ORCF underwriters are required to complete while underwriting loans.

Results of Audit

Finding: HUD Generally Approved Section 232 FHA-Insured Loans in Accordance With HUD Requirements

For the three loan files reviewed, valued at nearly $50 million, HUD maintained documentation to show that it adequately reviewed (1) loan applications for program eligibility; (2) financial operations of the operator; (3) the creditworthiness of the borrower, operator, and operator parent; (4) professional liability insurance; and (5) the project capital needs assessment. However, it did not adequately evaluate the creditworthiness of the management agents as required. This condition occurred because HUD's underwriters did not follow procedures. As a result, if HUD does not implement controls and procedures to ensure that it properly evaluates the creditworthiness of management agents, it could approve loans for projects with management agents that significantly impact the financial position of the project. After we notified HUD of this issue, it took immediate corrective action to ensure that it adequately evaluates the creditworthiness of management agents when underwriting future loans.

Loan Applications Met Program Eligibility

For the three files reviewed, HUD adequately reviewed the loan applications for program eligibility. According to the section 232-223(f) punch list, a preapproved lender was required to review the loan application before it was submitted to HUD for review. In addition, the borrower was required to meet loan-to-value requirements based on whether it was classified as a nonprofit or for-profit entity. Also, the punch list required underwriters to review previous participation documents and identify any identities of interest with the lender. For the three files reviewed, HUD maintained documentation, such as an approved lender listing; calculations of each project's loan-to-value percentage; copies of previous participation forms and related HUD approvals; and copies of form HUD-90013, Consolidated Certification, identifying any identities of interest. This documentation showed that an approved lender was used, HUD verified that all three loans met the loan-to-value requirements, underwriters conducted previous participation reviews for required entities, and HUD verified that no identities of interest existed with the lender.

HUD Adequately Reviewed the Financial Operations for the Operator

According to the punch list, HUD was required to review the financial operations and appraisals for the operator. The punch list also required ORCF underwriters to review third-party appraisal reports and ORCF's appraisal reviews to determine whether the value conclusions in the reports agreed with the lender narrative. In addition, the punch list required underwriters to review the operator's financial statements to determine its financial position. For the three loans reviewed, HUD adequately reviewed the financial operations of the operator, which included documentation, such as third-party appraisal reports and ORCF's appraisal review, the lender's review of the operator's financial statements, and the underwriter's verification that net operating income was acceptable and generally in line with the operator's historical net operating income.

HUD Adequately Reviewed the Creditworthiness of the Borrower, Operator, and Operator Parent

For the three loans reviewed, HUD adequately reviewed the creditworthiness of the borrower, operator, and operator parent. The three loans were submitted as part of a large portfolio[3] of 48 loans with a combined mortgage amount totaling more than $433 million. According to HUD Handbook 4232.1, chapter 17, a portfolio corporate credit review is required for all midsize and large portfolios.[4] Portfolio corporate credit review procedures apply to owners and operators to assess the credit risk. HUD reviews all materials submitted in the portfolio corporate credit review and determines whether the portfolio is an acceptable risk to the general insurance fund based on operation and ownership experience, financial strength, quality indicators, and any pending legal issues including the jurisdictional regulatory environments. Once HUD completes the review, it issues a corporate credit review memorandum notifying the lender of approval or rejection for individual applications. For the three loans reviewed, HUD adequately assessed the borrower, operator, and operator parent's financial strength, quality of care, and ownership experience during the corporate credit review. The corporate credit memorandum contained a detailed review of the financial position, history with HUD, and ownership experience and provided organizational charts and resumes to show that the entities had experience in the senior care industry.

Loan Applications Met Professional Liability Insurance Requirements

According to HUD Handbook 4232.1, appendix 14.1, professional liability insurance requirements apply to new applications on behalf of residential care facilities seeking mortgage insurance under section 232(f) for the purchase or refinance of an existing facility. In addition, the punch list required that a professional liability analyst perform a professional liability insurance review of large portfolios before issuing a firm commitment. For the three loans reviewed, HUD adequately reviewed the professional liability insurance and ensured that the loan applications met the professional liability insurance requirements. Because all three loans had common ownership and were part of a large portfolio, a 50-plus operator review of the professional liability insurance was completed. HUD maintained documentation, such as the operator's financial statements; copies of approved waivers; State licensing surveys; and a memorandum containing the results of HUD's review of the operator's loss histories, claim history, and Center for Medicare and Medicaid Services ratings, to show that it reviewed the operator's financial performance, loss histories, applicable waivers, claims history, and Center for Medicare and Medicaid Services ratings.

Project Capital Needs Assessments Were Completed and Reviewed

For the three loans reviewed, HUD adequately reviewed the project capital needs assessments, which were completed by a third party and submitted by the lender. The project capital needs assessments reported on the physical condition of the property and recommended repairs. HUD verified that the repairs suggested by the lender were in line with the needs assessor's repair conclusions. Also, HUD verified that repairs were clearly described and the projects met

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[3] The borrower was the same for these 48 loans.

[4] Midsize portfolio = up to 49 facilities and a total mortgage amount > $90 million and ≤ $250 million. Large portfolio = 50 or more facilities and a total mortgage amount > $250 million.

accessibility requirements. For the three loans, the projects needed critical and noncritical repairs. The costs of those repairs were being financed as part of the refinance transaction. In addition, HUD ensured that the lender provided a replacement reserve funding schedule to show the projects' proposed initial and annual deposit and a positive reserve balance for the first 15 years. According to the punch list, the recommended minimum balance for the replacement reserve account was $1,000 per unit. For the three projects reviewed, the replacement reserve funding schedule showed that the projects had 109 units, 69 units, and 64 units with initial deposits totaling $109,000, $69,000, and $64,000 and annual deposits totaling $128,075, $103,500, and $81,280, respectively.

HUD Did Not Adequately Evaluate the Creditworthiness of Management Agents

According to the punch list, underwriters were required to evaluate the creditworthiness of the management agent. Specifically, underwriters were required to review the lender narrative, credit reports, and the Consolidated Certification and perform internet searches for potential investigations or litigation. If any of the sources reported delinquent Federal debt, judgments, lawsuits or legal actions, bankruptcies, tax liens, or Medicare-Medicaid fraud, the ORCF underwriter was required to have the lender address any issues before HUD issued a firm commitment. According to 24 CFR (Code of Federal Regulations) 200.230, a principal[5] may be disapproved for participation if there are unresolved findings as a result of HUD or other government audits or investigations. In addition, HUD Handbook 4232.1, chapter 6, states that a principal may be rejected if there are judgments or actions against the principal that (1) could significantly impact the financial position of the individual, firm, or corporation or (2) result in a determination that the individual, firm, or corporation is an unacceptable credit risk.

For the three files reviewed, the borrower used the same management agent. We reviewed the credit report for the management agent and found that there were no significant issues. However, we performed an internet search on the management agent and found that it was a defendant in a legal action[6] in which a complainant accused the management agent of Medicare and Medicaid fraud. The complainant alleged that while working at a nursing home facility, which was managed by the management agent company, the complainant witnessed staff submitting false Medicare and Medicaid claims. The initial complaint was filed in June 2011; however, the management agent company was not specifically named as a defendant until an amended complaint was filed in June 2013. According to a news article, in February 2017, a Florida Federal jury found that the management agent company, along with operators of 52 skilled nursing facilities, was liable for more than $115 million in damages stemming from the false claims. Specifically, the jury ruled that the management agent should be held liable for $109.8 million in damages for submitting 123 false Medicare claims. However, in January 2018, a Federal court in Florida overturned the jury verdict. When the lender submitted the application to HUD in January 2016, this case was ongoing, and the issue was not addressed by the lender or

[5] A principal is defined as a principal or private entity proposing to participate in a project as a borrower, operator, parent of the operator, management agent, general contractor, or the like. A principal may have an active role in a project and direct the activities and affairs of the borrower entity or be involved in decision making, or a principal may have a passive role in which the principal's participation is limited to an ownership interest in the project.

[6] United States ex rel. Angela Ruckh v. Salus Rehabilitation, LLC, et al

HUD. The lender disclosed this specific legal action in the Consolidated Certification. However, HUD did not review this document and did not address this issue before issuing the firm commitment. This condition occurred because the underwriters did not follow procedures. The underwriters' supervisor stated that they relied heavily on the lender narrative and the lender narratives for these three loans did not disclose the legal action. However, the Consolidated Certification disclosed the legal action. Therefore, the underwriters should have been aware of the legal action because the punch list required them to review the Consolidated Certification. If HUD does not implement controls and procedures to ensure that it properly evaluates the creditworthiness of management agents, it could approve loans for projects with management agents that significantly impact the financial position of the project.

HUD Took Action To Correct the Issue

After we notified HUD of the issue, it took immediate corrective action to ensure that it adequately evaluates the creditworthiness of management agents when underwriting future loans. It updated the punch list by adding additional review steps, to include requesting that the Office of General Counsel review the Consolidated Certification form and identify any material legal issues. The updated punch list will also require the underwriter to perform additional internet searches on the project, borrower, operator, management agent, and their principals and parent organizations to identify any significant adverse information before the loan committee decides whether to issue the firm commitment. On July 19, 2018, HUD implemented the updated punch list by issuing a memorandum to its underwriters and managers to inform them that the updated punch list was effective immediately.

Conclusion

HUD generally approved Section 232 FHA-insured loans for projects that qualified for mortgage insurance in accordance with HUD requirements. However, for three loans reviewed, it did not adequately evaluate the creditworthiness of management agents as required. Without controls and procedures to ensure that it properly evaluates the creditworthiness of management agents, HUD could approve loans for projects with management agents that significantly impact the financial position of the project. During the audit, HUD took immediate corrective action to ensure that it adequately evaluates the creditworthiness of management agents when underwriting future loans.

Recommendations

We recommend that the Deputy Assistant Secretary for Healthcare Programs

1A. Develop and implement controls and procedures to ensure that HUD's underwriters properly evaluate the creditworthiness of management agents when underwriting future loans.

    On July 19, 2018, HUD implemented the recommendation by updating its punch list and issuing a memorandum to its underwriters and managers to inform them that the updated punch list was effective immediately. Therefore, no further action is required by the Office of Healthcare Programs. At issuance of this audit report, we will enter a management decision into HUD's Audit Resolution and

Corrective Action Tracking System, along with the updated punch list and memorandum, to show that final action was completed.

Scope and Methodology

We conducted the audit from October 2017 through July 2018 at our office located in Philadelphia, PA. The audit covered the period October 2015 through September 2017.

To accomplish our objective, we reviewed

- relevant background information, including portfolio data and prior HUD Office of Inspector General (OIG) audit reports.
- the National Housing Act of 1959.
- applicable HUD regulations; HUD Handbook 4232.1, REV-1; HUD Notice H 2016-15; and punch lists related to section 232-223(f) loans.
- HUD's organizational chart and employee listing.

We interviewed staff from HUD's Office of Healthcare Programs and Office of Residential Care Facilities.

To achieve our audit objective, we relied in part on computer-processed data from HUD's Multifamily Data Mart, Multifamily Delinquency and Default Reporting system, and the Online Property Integrated Information Suite. Although we did not perform a detailed assessment of the reliability of the data, we did perform a minimal level of testing and found the data to be adequate for our purposes at the time of review. The testing entailed comparing loan information in HUD's system to the electronic loan files provided by HUD.

As of October 2017, the Section 232 program portfolio included 4,086 active loans with original loan amounts totaling more than $28.5 billion and unpaid principal balances totaling more than $26.1 billion. The loans had final endorsement dates between May 1986 and October 2017. To narrow our universe, we focused on loans with final endorsement dates during the period October 1, 2015, through September 30, 2017. During that period, there were 569 loans with original loan amounts totaling more than $5.9 billion and unpaid principal balances totaling more than $5.8 billion. Based on an initial analysis of the data, we identified 28 loans that were delinquent and refinanced. We sorted the 28 loans and selected 3 of the 4 loans with the highest original loan amounts totaling nearly $50 million, with unpaid principal balances of more than $48.8 million. HUD issued firm commitments for these three loans on July 29, 2016.

During our review of the sample loan files and additional analysis of the data, we determined that the initial universe of 28 delinquent and refinanced loans was incorrect. Of the 569 loans with final endorsement dates within our audit period, 543 were refinances and only 1 was previously delinquent. Therefore, less than 1 percent of the loans endorsed during the audit period was delinquent. Although our initial approach to review loans that were delinquent and refinanced was flawed, the results of our review are valid because nearly all of the loans endorsed during the audit period had not been delinquent and we reviewed three of them to determine whether HUD approved Section 232-FHA insured loans for projects that qualified for mortgage insurance in accordance with applicable HUD requirements.

We conducted the audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Internal Controls

Internal control is a process adopted by those charged with governance and management, designed to provide reasonable assurance about the achievement of the organization's mission, goals, and objectives with regard to

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Internal controls comprise the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations as well as the systems for measuring, reporting, and monitoring program performance.

Relevant Internal Controls

We determined that the following internal controls were relevant to our audit objective:

- Program operations – Policies and procedures that management has implemented to reasonably ensure that a program meets its objectives.

- Validity and reliability of data – Policies and procedures that management has implemented to reasonably ensure that valid and reliable data are obtained, maintained, and fairly disclosed in reports.

- Compliance with applicable laws and regulations – Policies and procedures that management has implemented to reasonably ensure that the use of resources is consistent with laws and regulations.

We assessed the relevant controls identified above.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

We evaluated internal controls related to the audit objective in accordance with generally accepted government auditing standards. Our evaluation of internal controls was not designed to provide assurance regarding the effectiveness of the internal control structure as a whole. Accordingly, we do not express an opinion on the effectiveness of HUD's internal control.

Appendix

Appendix A

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

OFFICE OF HOUSING

July 19, 2018

MEMORANDUM FOR: David E. Kasperowicz, Regional Inspector General for Audit, Philadelphia Region, 3AGA

FROM: Roger Lukoff, Deputy Assistant Secretary, Office of Healthcare Programs, HP

SUBJECT: Comments to HUD OIG Draft Report Titled: Office of Healthcare Programs, Washington, DC, HUD's Approval of Section 232 FHA-Insured Loans

This memorandum responds to your draft audit report titled HUD's Office of Healthcare Programs, Washington, DC, HUD's Approval of Section 232 FHA-Insured Loans. OHP is providing HUD OIG with the documentation of updated processes that have been implemented which relate to OIG's recommendation.

__Recommendation (1A)__: Develop and implement controls and procedures to ensure HUD's underwriters properly evaluate the creditworthiness of management agents when underwriting future loans.

Comment 1

__Comment 1: Actions Taken to Date__: We concur with this recommendation. In response to this finding, we have made the following changes to the punchlist. Please note that we are extending the new procedure to include the borrower, operator and principal of the operator in addition to the management agent.

Punchlist sections: C2 Borrower
D2 Operator
E2 Parent Operator
F2 Management Agent

Comment 1

Office of Residential Care Facilities (ORCF) underwriters will do an internet search on all principals of the Consolidated Certifications. For any questionable findings, the underwriter will request an explanation from the lender and may also request OGC assistance in interpreting the matter in order to determine the potential impact and risk to the long-term viability if the FHA-insured loan.

www.hud.gov espanol.hud.gov

Auditee Comments and OIG's Evaluation

Ref to OIG Evaluation

Auditee Comments

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If you have any questions regarding this matter, please contact Jennifer Buhlman at 202-402-6722.

Cc: Roger Lewis
Patrick Berry
Jen Buhlman

Attachments: Memo to ORCF Underwriters
Updated 223(f) Punchlist
Draft Audit Report

OIG Evaluation of Auditee Comments

Comment 1 HUD stated that it concurred with the recommendation. It also stated that it made changes to the punch list and is extending the new procedure to include the borrower, operator and principal of the operator, and the management agent. It further stated that its ORCF underwriters would perform internet searches on all principals of the Consolidated Certification. HUD stated that if it identifies any questionable findings, it would request an explanation from the lender and may also request assistance from the Office of General Counsel to interpret the matter to determine the potential impact and risk to the long-term viability of the FHA-insured loan. HUD issued a memorandum to its underwriters and managers on July 19, 2018, implementing the updated punch list effective immediately. We reviewed the updated punch list and the memorandum and confirmed that HUD's actions sufficiently addressed the intent of our recommendation. We will close this recommendation concurrent with the report issuance.