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GAO

Report to Congressional Addressees

May 2006

RESIDENTIAL CARE FACILITIES MORTGAGE INSURANCE PROGRAM

Opportunities to Improve Program and Risk Management

GAO

Accountability ★ Integrity ★ Reliability

GAO-06-515

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Highlights

Highlights of GAO-06-515, a report to congressional addressees

Why GAO Did This Study

Through its Section 232 program, the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) insures approximately $12.5 billion in mortgages for residential care facilities. In response to a requirement in the 2005 Consolidated Appropriations Conference Report and a congressional request, GAO examined (1) HUD's management of the program, including loan underwriting and monitoring; (2) the extent to which HUD's oversight of insured facilities is coordinated with the states' oversight of quality of care; (3) the financial risks the program poses to HUD's General Insurance/Special Risk Insurance (GI/SRI) Fund; and (4) how HUD estimates the annual credit subsidy cost for the program.

What GAO Recommends

GAO recommends, among other things, that the HUD Secretary establish a process for sharing practices among field offices, assure appropriate levels of staff with appropriate expertise, and incorporate reviews of federal or state inspection reports into loan monitoring. GAO also recommends that HUD explore factoring additional information into its credit subsidy model. In written comments, HUD agreed with all of GAO's recommendations except exploring the value of adding certain factors to its credit subsidy model.

www.gao.gov/cgi-bin/getrpt?GAO-06-515.

To view the full product, including the scope and methodology, click on the link above. For more information, contact David G. Wood at (202) 512-6878 or WoodD@gao.gov.

May 2006

RESIDENTIAL CARE FACILITIES MORTGAGE INSURANCE PROGRAM

Opportunities to Improve Program and Risk Management

What GAO Found

While HUD's decentralized program management allows its 51 field offices flexibility in their specific practices, GAO found differences in the extent to which staff in the five field offices it visited were aware of current program requirements. For example, four offices were unaware of required addendums to the programs' standard regulatory agreement. Further, while individual offices had developed useful practices for loan underwriting and monitoring, they lacked a mechanism for systematically sharing such practices with other offices. Also, field office officials were concerned about adequate current or future levels of staff expertise—a critical factor in managing program risk in that health care facility loans are complicated and require specialized knowledge and expertise.

FHA requires a review of the most recent annual state-administered inspection report for state-licensed facilities applying for program insurance, and recommends, but does not require, continued monitoring of such reports for facilities once it has insured them. Four of the five HUD field offices GAO visited do not routinely collect annual inspection reports for their insured facilities. While the reports are but one of several monitoring tools, they provide potential indicators of future financial risk. HUD has proposed revising its standard regulatory agreements to require insured facility owners or operators to submit annual inspection reports and to report notices of violations. However, the proposed revisions have been awaiting approval since August 2004, and the implementation date is uncertain.

The Section 232 program accounts for only about 16 percent of the GI/SRI Fund's total unpaid principal balance, but program and industry trends pose potential risks to the Section 232 program and to the GI/SRI Fund. For example, in recent years the program has insured increasing numbers of assisted living facility loans and refinancing loans, for which there are limited data available to assess long-term performance. Other potential risk factors include increasing prepayments (full repayment before loan maturity) and loan concentration in several large markets and among relatively few lenders. Projected shifts in demand for residential care facilities could affect currently insured facilities and the overall market for the types of facilities that HUD insures under the program.

To estimate the program subsidy cost, HUD uses a model to project cash flows for each loan cohort (the loans originated in a given fiscal year) over its entire life. HUD's model does not explicitly or fully consider certain factors, such as loan prepayment penalties, interest rate changes, or differences in loans to different types of facilities, and uses some proxy data that is not comparable to Section 232 loans. The model's exclusion of potentially relevant factors and it use of this proxy data could affect the reliability of HUD's credit subsidy estimates.

Contents

Abbreviations

CON	Certificate of Need
DAP	Development Application Processing
FASAB	Federal Accounting Standards Advisory Board
FASS	Financial Assessment Subsystem
FHA	Federal Housing Administration
GI/SRI	General Insurance/Special Risk Insurance
HUD	U.S. Department of Housing and Urban Development
LQMD	Lender Quality Management Division
MAP	Multifamily Accelerated Processing
OMB	Office of Management and Budget
TAP	Traditional Application Processing
OPIIS	Online Property Integrated Information Suite

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Congressional Addressees

Through its Section 232 Mortgage Insurance for Residential Care Facilities program (Section 232 program), the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA) insures mortgages for nursing homes, assisted living facilities, board and care homes, and intermediate care facilities. As of December 31, 2005, the program insured mortgages with an unpaid principal balance of approximately $12.5 billion.[1] The program insures HUD-approved private lenders against financial losses from loan defaults; insured loans can be used to finance the purchase, construction, or rehabilitation of a facility, enable borrowers to refinance projects that do not need substantial rehabilitation, or to install fire safety equipment.

For budget and accounting purposes, the Section 232 program is part of HUD's General Insurance/Special Risk Insurance (GI/SRI) Fund; other programs in the GI/SRI Fund provide mortgage insurance for various types of multifamily housing projects and for hospitals. HUD is required to annually estimate the subsidy cost, or the cost to the federal government of guaranteeing credit to residential care facilities over the life of the loans.[2] This estimate requires FHA to forecast future cash flows associated with the loans, which can be influenced by factors that are associated with the potential risks facing the program's loan portfolio.

While private lenders may finance the purchase or construction of nursing homes, public funding, including Medicare and Medicaid, has accounted for an increasing percentage of spending on nursing home care.[3] For example, in 2000 Medicare and Medicaid financed 39 percent of the nation's

[1]Based on data from the HUD's F47 multifamily database.

[2]Pursuant to the Federal Credit Reform Act of 1990, HUD must annually estimate the credit subsidy cost for all of its loan guarantee programs.

[3]Medicare is the federal health care program for the elderly and people with disabilities. In addition to other health services, Medicare covers up to 100 days of nursing home care following a hospital stay. Medicaid is the joint federal-state health care financing program for certain categories of low-income individuals, including elderly and disabled individuals. Medicaid also pays for long-term care services, including nursing home care.

spending on nursing home care, up 28 percent from 1990.[4] In 2004, Medicare accounted for 14 percent and Medicaid accounted for 44 percent of the nation's spending on nursing home care, and the total of all public funds, including Medicare and Medicaid, accounted for approximately 61 percent.[5] Federal and state governments share responsibility for oversight of nursing homes that participate in the Medicare and Medicaid programs. The U.S. Department of Health and Human Services defines standards that nursing homes must meet to participate in the Medicare and Medicaid programs and contracts with states to conduct annual inspections.[6] Generally, states license nursing homes (and in some cases related facilities) and oversee their operations through inspections.

The 2005 Consolidated Appropriations Conference Report mandated that we review the design and management of two FHA mortgage insurance programs —those for the Section 232 program and the Section 242 Hospital Mortgage Insurance program.[7] In addition, the Ranking Member of the Subcommittee on Housing and Transportation, Senate Committee on Banking, and others requested that we review several aspects of the Section 232 program. Accordingly, this report provides both the results of the mandated review and our response to the request. Specifically, we examined: (1) HUD's management of the program, including loan underwriting and monitoring; (2) the extent to which HUD's oversight of insured residential care facilities is coordinated with the states' oversight of the quality of care provided by those facilities that are subject to state licensing or inspection; (3) the financial implications of the program to the GI/SRI Fund, including risk posed by program and market trends; and (4) how HUD estimates the annual credit subsidy for the program, including the factors and assumptions used. In addition, we examined HUD's action in response to a HUD Inspector General report that concluded that HUD's

[4]GAO, *Nursing Homes: Quality of Care More Related to Staffing than Spending*, GAO-02-431R (Washington, D.C.: June 13, 2002), 1.

[5]GAO analysis of data from the U.S. Department of Health and Human Services, Centers for Medicare & Medicaid Services.

[6]While we refer to these inspections as annual, every nursing home receiving Medicare or Medicaid payments must undergo a standard inspection survey not less than once every 15 months, and the statewide average interval for these surveys must not exceed 12 months.

[7]We provided the results of the mandated study of the Hospital Mortgage Insurance program in GAO, *Hospital Mortgage Insurance Program: Program and Risk Management Could be Enhanced*, GAO-06-316 (Washington, D.C.: Feb. 28, 2006).

Office of Housing did not have adequate controls to effectively manage the Section 232 program; this information is summarized in appendix III.

To address these objectives, we reviewed program manuals and documentation of loan processing procedures and underwriting requirements and analyzed program financial data that we tested and found reliable for our purposes.[8] In examining HUD's management of the program, we focused on how underwriting and loan monitoring activities were carried out through visits to five of HUD's field offices (Atlanta, Georgia; Buffalo, New York; Chicago, Illinois; Los Angeles, California; and San Francisco, California), where we interviewed program officials and obtained relevant documents in each office.[9] We also reviewed documentation of the model HUD uses to estimate program subsidy costs, applicable program laws, regulations, and policy statements. We obtained relevant program documentation and interviewed headquarters officials in HUD's Office of Multifamily Development and Office of Asset Management and HUD's Office of Evaluation and Office of Inspector General. We also interviewed representatives of residential care associations; lenders with loans insured by the program, as well as other private lenders that offer non-FHA-insured residential care loans; and representatives of nursing homes and assisted living facilities. Our review did not include an evaluation of the need for the Section 232 program. See appendix I for more detailed information on our objectives, scope, and methodology.

We conducted our work in Washington, D.C., and the HUD field office locations noted above between February 2005 and April 2006 in accordance with generally accepted government auditing standards.

Results in Brief

While HUD's decentralized management of the Section 232 program allows field offices some flexibility in their specific practices, in our visits to five field offices we found a lack of awareness of some current program requirements, potentially useful loan underwriting and monitoring

[8]Underwriting refers to the process of determining the risk of particular loan applications.

[9]We selected these locations on the basis of several factors for each office, including (1) the historical claim rates experienced among loans processed, (2) the volume and dollar amounts of loans, (3) insurance application processing times, and (4) discussions with HUD officials. Because we did not select the offices randomly, we do not know the extent to which they are representative of all HUD's field offices that process Section 232 program loans.

practices developed in individual offices that were not systematically shared with other offices, and concerns by field office managers about current or future levels of staff expertise. For example, four of the field offices were not aware of a notice that disqualifies potential Section 232 borrowers if they have had a bankruptcy in their past, and four offices were unaware of required addendums to the programs' standard regulatory agreement regarding certain state licensing requirements for nursing homes. While individual offices had developed useful practices for implementing the program's loan underwriting and monitoring requirements, they lacked a mechanism for systematically sharing practices with other offices. For example, two field offices included asset management staff—persons that monitor and oversee a loan after it has been insured—in the underwriting stages of loans to better assess their risks, while the other field offices did not. We also found that field office officials were concerned about adequate current or future levels of staff expertise—a critical factor in avoiding unwarranted risk in the Section 232 program, in that health care facility loans are generally more complicated and require more specialized knowledge and expertise compared with loans insured under HUD's other multifamily programs. Lack of awareness of current requirements and insufficient staff expertise can contribute to the program insuring loans with increased risks.

FHA's coordination with states' oversight of residential care facilities' quality of care provided to residents is limited. FHA requires field office officials to review the most recent annual state administered inspection report for existing state-licensed facilities as part of the application. HUD recommends, but does not require, that officials continue monitoring annual inspection reports for a residential care facility once it is insured, particularly if the officials do not perform an on-site management review (an examination of operations, occupancy, financial management, and possible quality of care issues) of the facility. Four of the five HUD field offices we visited do not routinely review annual inspection reports for the insured facilities they oversee; further, HUD field offices conduct a limited number of management reviews of Section 232 facilities. While annual inspection reports are but one of several means of monitoring insured properties, FHA's limited use of them may lead the agency to miss potential indicators of risk for some of its insured loans. Because serious quality of care deficiencies can have a variety of implications that affect cash flow streams, ranging from a related reduction in occupancy to the more direct financial implications such as civil money penalties and loss of licensing and reimbursements, they may ultimately affect a facility's ability to repay the loan. Some private lenders told us they use the annual state inspection reports in coordination with other financial indicators to assess the financial risk of loans to facilities subject to state inspections. HUD is in the process of revising its residential care facility regulatory agreements—which establish loan conditions applicable to an owner and potential operator—to require owners or operators to (1) submit to HUD annual inspection reports and (2) report to HUD any notices of inspection violations. However, the proposed revisions have been awaiting approval since August 2004, and it is not clear when the revised agreements will be approved.

Although the Section 232 program is a small component of the GI/ SRI Fund—representing approximately 16 percent of the total unpaid principal balance—program and industry trends may pose financial risks to the fund. For example:

- In recent years, HUD has insured increasing numbers of mortgages that are refinances of existing loans, as well as loans for assisted living facilities. Because these types of loans are relatively new to the portfolio, there are limited data to observe long-term claim trends, making their risk difficult to assess. However, the 5-year claim rate (the portion of loans leading to a claim within 5 years of origination) was significantly higher for more recent assisted living facility loans.

- The proportion of loans that terminate due to prepayment within 10 years of origination is increasing. Prepayment occurs when a borrower pays a loan in full before the loan reaches maturity. As more borrowers prepay their loans, HUD loses future cash flows of premiums. Such losses could be offset to some extent, in that prepayments may ultimately result in fewer claims.

- Program loans are concentrated in several states and among relatively few lenders. As of 2005, five states (California, Illinois, Massachusetts, New York, and Ohio) accounted for 51 percent of active loan amounts, with one state—New York—representing 24 percent. Further, while a total of 109 lenders held active loans, just 6 held over half of the active loan portfolio. Geographic concentration makes the program vulnerable to swings in regional economic conditions, while concentration among lenders potentially makes the program more vulnerable if one or a few large lenders encounters financial difficulty.

In addition, industry developments and uncertainty in the funding of the Medicaid and Medicare programs pose potential risks. Projected shifts in demand for residential care facilities could affect not only the facilities currently insured by HUD but also the overall market for the particular types of facilities that HUD insures under the program.

To estimate the subsidy cost of the Section 232 program, HUD uses a cash flow model to project the expected cash flows for all of these loans over their entire life. The cash flow model uses assumptions based on historical and projected data to estimate the amount and timing of claims, subsequent recoveries from these claims, prepayments, and premiums and fees paid by the borrower. We found that HUD's model does not explicitly consider certain factors such as loan prepayment penalties or lockouts (the period of time during which prepayment is prohibited), which can affect whether and when a loan is prepaid and may also show changes in the risk of claim and expected collections of premiums. HUD's cash flow model also does not fully capture the effects on existing loans when market interest rates change, nor explicitly consider differences in loan performance between different types of facilities. Furthermore, the model includes some proxy data with borrower characteristics and performance that is not comparable to Section 232 loans. The model's exclusion of potentially relevant factors and its use of this proxy data could affect the reliability of HUD's credit subsidy estimates.

This report contains recommendations to HUD designed to ensure that field offices understand and implement current program requirements, including sharing practices among field offices. We also recommend that HUD incorporate reviews of annual inspection reports for nursing homes and other residential care facilities into its loan monitoring process, complete its proposed revision to the residential care facility regulatory agreement in a timely manner, and consider including additional variables and methods in its credit subsidy modeling. We provided a draft of this report to HUD and received written comments from the Assistant Secretary for Housing, which are discussed later in this report and in appendix V. In its response, HUD generally concurred with our recommendations intended to ensure that field offices are aware of and implement current program requirements and policies, but disagreed with most parts of our recommendation related to HUD's credit subsidy model. Specifically, HUD did not agree to consider factoring additional information into its credit subsidy model including prepayment penalties and restrictions, initial loan-to-value and debt service coverage ratios, and the ratio of contract rates and market rates. Because we believe that factoring such information into the credit subsidy model could be useful, we did not modify our recommendation.

Background

Section 232 of the National Housing Act, as amended, authorizes FHA to insure mortgages made by private lenders to finance the construction or renovation of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities.[10] Congress established the Section 232 program in 1959 to provide mortgage insurance for the construction and rehabilitation of nursing homes. The Housing and Community Development Act of 1987 expanded the program to allow for the insuring of refinancing or purchase of FHA-insured facilities and, in 1994, HUD issued regulations implementing legislation to expand the program to allow for the insuring of assisted living facilities and the refinancing of loans for facilities not previously insured by FHA. Since 1960, FHA has insured 4,372 loans through the Section 232 program in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico. As of the end of fiscal year 2005, there were 2,054 currently insured loans.

FHA does not insure all residential care facilities, as there are approximately 16,500 nursing home facilities and over 36,000 assisted living facilities in operation.[11] We did not identify any private mortgage insurance that is currently available for loans made to nursing homes or other similar facilities. According to HUD officials, in recent times, the Section 232 program exists, in part, to support the market for residential care facilities when the private market is reluctant to finance such projects due to market conditions. The loans are advantageous to borrowers because they are nonrecourse loans whereby the lender (in this case the lender and the insurer, FHA) has no claim against the borrower in the event of default and can only recover the property. The loans are also generally long term (in some cases up to 40 years) and, according to HUD and lender officials,

[10]According to HUD's "Section 232 Mortgage Insurance for Residential Care Facilities Handbook," nursing homes are those facilities that provide accommodation for persons who are not acutely ill and not in need of hospital care but require skilled nursing care and related medical services. Intermediate care facilities provide for the accommodation of persons who require minimum, but continuous care, and do not require skilled nursing services. In this report, we use the term "nursing home" to include facilities providing skilled and/or intermediate care services. Assisted living facilities are facilities for residents who need assistance with activities of daily living. Board and care facilities provide room, board, and continuous protective oversight.

[11]Based on 2003–2005 data in GAO, *Nursing Homes: Despite Increased Oversight, Challenges Remain in Ensuring High-Quality Care and Resident Safety,* GAO-06-117 (Washington, D.C.: Dec. 28, 2005), 60, and 2004 data in Robert Mollica and Heather Johnson-Lamarche, *State Residential Care and Assisted Living Policy: 2004* (National Academy for State Health Policy, March 2005), 1-2.

offer an interest rate that is, in many cases, lower than what private lenders offer for non-FHA insured loans made to nursing homes and other similar facilities. Additionally, FHA insures 99 percent of the unpaid principal balance plus accrued interest.

HUD administers the Section 232 program through its field offices, with HUD headquarters oversight. HUD's field structure consists of 18 Hub offices and 33 program centers. Generally, each Hub office has a number of program centers that report to it. Program centers administer multifamily programs within the states in which they are located or portions thereof. Hub offices also administer multifamily programs, as well as augment the operations of and coordinate workload between their program centers.

Under Medicaid, states set their own nursing home payment rates (reimbursement rates), and the federal government provides funds to match states' share of spending as determined by a federal formula. Within broad federal guidelines, states have considerable flexibility to set reimbursement rates for nursing homes that participate in Medicaid but are required to ensure that payments are consistent with efficiency, economy, and quality of care.[12] Under Medicare, skilled nursing facilities receive a federal per diem payment that reflects the resident's care needs and is adjusted for geographic differences in costs.

[12]42 U.S.C. §1396a(a).

HUD's Decentralized Management Provides Field Offices Flexibility, but Varying Awareness of Underwriting and Monitoring Practices and Concerns Over Insufficient Staff Expertise Increase Program's Potential Risks

While the decentralization of the program allows field offices some flexibility in their specific practices, the results of our visits to five field offices revealed differences in the extent to which field office staff were aware of current program requirements. Further, while individual offices had developed useful practices for implementing the program's loan underwriting and monitoring requirements, they lack a mechanism for systematically sharing practices with other offices. We also found that field office officials were concerned about adequate current or future levels of staff expertise—a critical factor in avoiding unwarranted risk in the Section 232 program, in that health care facility loans are generally more complicated and require specialized expertise compared with loans insured under HUD's other multifamily programs. Lack of awareness of current requirements and insufficient staff expertise can contribute to insuring loans with increased risks. Both factors are related to recommendations made in the HUD Office of Inspector General's 2002 report that HUD has not fully addressed (see app. III for further information on weaknesses identified by HUD's Inspector General).

Some Field Offices Were Not Aware of All Current Program Requirements

FHA has numerous underwriting requirements for loans insured under the Section 232 program; for example, facilities must provide evidence of market need; a (real estate) appraisal; and be in compliance with limits on loan-to-value and debt service coverage ratios.[13] FHA also requires a variety of reviews for monitoring Section 232 loans. (Loan underwriting and monitoring requirements, which can involve fairly complex reviews and analyses, are described in more detail in app. II.)

According to HUD headquarters officials, the field offices that administer the Section 232 program are required to follow all program statutes and regulations, but the decentralization of the program allows field offices some flexibility in their specific practices. For example, individual field offices can designate how to staff the underwriting and monitoring of Section 232 loans, depending on such factors as loan volume relative to other multifamily programs, to fully utilize resources. HUD headquarters provides guidance on program policies and requirements; when necessary, reviews applications for certain types of loans, such as those submitted by

[13]Loan-to-value is a ratio of the amount of the loan as a percentage of the property's value or sales price. Debt service coverage ratio is the ratio of the property's annual net operating income to the annual debt service.

nonprofit entities; and provides technical assistance or additional guidance and support if contacted by field offices. HUD headquarters staff also conduct Quality Management Reviews, which are management reviews of field offices administering HUD programs and services. For these reviews, evaluators visit offices and coordinate subsequent reports. The process also involves reporting the status of follow-up corrective actions. While not focused on the Section 232 program, this process helps to oversee the program by reviewing the management of the field offices that administer it.

We found that the five field offices that we visited varied in their understanding and awareness of policies related to the Section 232 program. For example, staff in two field offices said that their standard regulatory agreement (that serves as the basic insurance contract and spells out the respective obligations of FHA, the lender, and the borrower) did not include language that would require operators of insured facilities to submit financial statements on new loans.[14] According to officials at HUD headquarters, field offices should be using language requiring these financial statements. HUD and most lender officials we interviewed told us that operator financial statements provide information on the legal entity operating the facility in cases where the borrower and the operator of the residential care facility are different entities. These officials also stated that, in such situations, borrower financial statements may not disclose expenses, income, and other financial information, and may only show the transactions between the borrower and operator, thus making operator financial statements a necessity. Also, HUD's Inspector General identified HUD's lack of a requirement for operators to submit financial statements electronically to be part of an internal control weakness for the Section 232 program.

Additionally, we found that the field offices that we visited were not always aware of specific notices that established new requirements or processes for the Section 232 program. For example:

- Four of the five field offices that we visited were not aware of a notice that disqualifies potential Section 232 borrowers if they have had a bankruptcy in their past. According to a HUD headquarters officials, this

[14]Officials in one field office explained that they had previously required operators to submit financial statements and were planning to resume following this requirement.

policy is intended to protect HUD from insuring a potentially risky loan based on a borrower's financial history.

- Officials at four of the five field offices we visited did not know about required addendums to the regulatory agreement regarding state licensing requirements for nursing homes. HUD developed these addendums to place a lien on a property's operational documents, such as a Certificate of Need and state licenses, to prevent operators from taking these documents with them upon termination of a property's lease.[15] Without these documents, a facility may not be able to operate and, consequently, the property's value would be greatly diminished.

According to HUD headquarters officials, HUD headquarters communicates changes in the Section 232 program's policies and procedures to field offices in a variety of ways besides sending formal notices. For example, HUD headquarters also posts some notices on a "frequently-asked questions" section of a Web site available to field offices, lenders, attorneys, and others.[16] HUD headquarters officials also conduct nationwide conference calls with the field offices in which various HUD multifamily programs, including the Section 232 program, are discussed. The conference calls are conducted separately for loan development staff and asset management staff that work, respectively, on the underwriting and monitoring of loans. HUD headquarters officials stated that these conference calls provide a forum to disseminate information to the field offices and for individual field offices to discuss any issues, questions, or concerns regarding any multifamily programs, including the Section 232 program.

HUD headquarters officials stated that they plan to address the lack of awareness we observed by updating the "Multifamily Asset Management and Project Servicing Handbook" to clarify current policies and requirements for the Section 232 program. HUD is also planning to update the handbook to address the 2002 HUD Inspector General report that identified that HUD's current handbook was not specific to Section 232

[15]A Certificate of Need is a state regulatory process that requires residential health care facilities to receive state approval before offering certain new or expanded health care services.

[16]According to headquarters officials, the Web site includes notices related to loan insurance applications processed under the Multifamily Accelerated Processing (MAP) system, which includes the majority of Section 232 loan applications.

nursing home operations. However, HUD officials told us the updates to the handbook would not be completed until the proposed revisions to the applicable regulatory agreements have been approved. The proposed revisions have been awaiting approval since August 2004, and it is not clear when the revised agreements will be approved.

Field Offices Do Not Systematically Share Information on Practices

As discussed earlier, field offices have some flexibility in practices that they use in administering the Section 232 program. In our visits to five field offices, we found a variety of practices that could be useful in the underwriting and monitoring of Section 232 loans if shared with other field offices. However, currently, HUD does not have systematic means by which to share this information among field offices.

Officials in two of the five field offices we visited identified specific practices they had developed to carry out loan underwriting requirements. For example:

- Asset management staff, whose focus is monitoring the performance of loans that are already insured, are asked to review a variety of documents submitted in the underwriting process, such as financial statements and information on the occupancy of the facility.
- In one of the offices, staff members may contact relevant state officials, just before the closing of a loan, to verify that the state has not identified any quality of care deficiencies since the facility submitted the application for mortgage insurance.
- Officials in one office stated that they conduct an additional review before approving a loan application for mortgage insurance to ensure that all required steps, such as mortgage credit analysis and valuation, have been properly performed.

According to the officials in these two offices, it is necessary to take these additional steps in order to adequately underwrite a loan under this program. They stated that the additional steps result in the better screening of loan risk and could result in the rejection of a risky loan they might otherwise approve.

We found a similar variety of practices in the monitoring of Section 232 loans. In some cases, field offices we visited had taken additional steps beyond those required by HUD. For example:

- While HUD requires a review of the annual financial statements of insured facilities, two field offices that we visited require monthly financial accounting reports from facilities either for the first year of the loan or until the facility has reached stable occupancy.

- Two field offices had developed their own specialized checklists for monitoring Section 232 loans. These checklists were specifically designed for the oversight of residential care facility loans and included items such as the facility's replacement reserve accounts and professional liability insurance, among other items.

- One of the offices had established a Section 232 working group, where underwriting and asset management staff met periodically to discuss loans in the portfolio and issues related to the overall management of the program in the field office. Additionally, three of the five field offices we visited had specialized staff with expertise in overseeing residential care facility loans. These were asset management staff whose primary or sole responsibility was oversight of the Section 232 portfolio.

- While HUD headquarters officials stated that they do not require management reviews of Section 232 facilities, three of the five field offices we visited conducted management reviews on some part of their Section 232 portfolios.

- One field office obtained the state annual inspection reports on its Section 232 facilities on a regular basis.

According to officials in these offices, the unique characteristics associated with residential care facilities make the additional measures necessary.

Officials in field offices we visited that had developed these specific practices stated that the practices result in better underwriting and monitoring of loans and could potentially help to prevent claims. However, HUD field offices do not have a systematic means by which to share information with other field offices about practices they have developed. While field office officials can raise concerns and issues through conference calls with HUD headquarters officials, most explained that these conference calls are not particularly designed for field offices to share practices with other field offices. Officials in the five field offices that we visited told us that they occasionally contact their counterparts in other field offices regarding loan processing or asset management questions or issues. Additionally, officials in some field offices said that they occasionally see their counterparts at regional lender conferences. However, aside from these forms of contact, there was no systematic method by which to learn about other field office practices. Consequently, officials in one field office are likely to be unaware of additional steps or practices taken by another field office that are intended to help officials improve underwriting or monitoring of Section 232 loans. Officials at all field offices that we visited told us that they could benefit from the sharing of such practices regarding underwriting and monitoring procedures established by different offices.

Officials Cited Concerns about Adequate Levels of Staff Expertise

Officials in two of the five field offices stated that a lack of expertise on residential care facility loans, either in underwriting or loan oversight, is a current concern in their office. They specifically noted a lack of expertise in residential care facilities and their overall management. Officials in all of the field offices that we visited stated that additional training on Section 232 loans would be beneficial to provide more knowledge and expertise, as there has been very little Section 232-specific training. In its 2002 report, HUD's Office of Inspector General also identified that field office project managers did not have sufficient training on reviewing Section 232 loans and dealing with the issues unique to Section 232 properties.

All of the private lenders we interviewed—those that offer non-FHA insured loans to residential care facilities and face similar risks to FHA—had a specialized group that conducted the underwriting of these loans. All of the individuals that conducted the underwriting of these loans were part of a health care lending unit that focused exclusively on loans made to health care facilities. According to the lenders, they believed it was necessary to have specialized staff underwriting such loans due to the unique nature of lending money to a facility that was designed for a residential health care business. Additionally, almost all of the private lenders we interviewed had specialized staff that monitored their residential care facility loans. According to lender staff we interviewed, nursing home and assisted living facility loans require an understanding of the market, trends, expenses, income, and other such unique characteristics associated with these types of facilities.

While officials in only two of the five offices expressed concern about the expertise of current staff, officials in all field offices we visited stated that they are concerned about the ability to adequately staff the Section 232 program in the next 5 years. They stated that as older staff retire in the next 5 years or so, any expertise that such staff currently have will take time to replace. All of the field offices that we visited staffed the underwriting process for Section 232 loans similar to that of other multifamily programs, based on workload and staff resources. However, while two field offices assigned their Section 232 properties, along with other multifamily properties, to general asset management staff for oversight, three field offices designated specific staff to oversee Section 232 properties. This was due to the latter field office officials' belief, similar to that of the private lenders we interviewed, that the properties require a certain level of knowledge and expertise associated with residential care facilities. Expertise in Section 232 loans allows for a better understanding of the distinct issues associated with oversight of residential care facilities. In one of the offices that had general asset management staff overseeing the portfolio, eight project managers shared responsibility for monitoring Section 232 properties in conjunction with other multifamily program properties. In contrast, in one of the offices with staff designated specifically for the Section 232 program, one member of the asset management staff was responsible for the entire Section 232 portfolio. Officials from the two field offices that have experienced staff specialized in monitoring Section 232 loans stated that they are concerned about losing their specialized staff over time and acknowledged that they will need to find replacements in order to continue to adequately monitor Section 232 loans. Their concern stems in part from the fact that Section 232 facilities, unlike other multifamily properties, require specialized knowledge and an understanding of the marketing, trends, and revenue streams associated with residential care facilities.

According to officials in all of the field offices that we visited, monitoring of Section 232 loans, when compared with other FHA-insured multifamily programs, requires additional measures. Section 232 loans contain a complex business component—the actual assisted living service or the nursing service operating in a facility—making them different from other multifamily programs that are solely realty loans. Consequently, for Section 232 loans, field office officials monitor the financial health of the business, including expenses, income, and other such items. Some field office officials also stated that it is important to monitor the operator to ensure that the facility is adequately managed. Additionally, some field office officials stated that to ensure the facility is generating enough income, they have to monitor Medicare and Medicaid reimbursement rates, as well as occupancy rates.

According to HUD headquarters officials, as part of its overall strategic human capital efforts, HUD is currently assessing the loss of human capital in field offices over time. However, this effort is not focused on the Section 232 program specifically but is intended to examine general human capital issues and needs.

FHA's Coordination with States' Oversight of Quality of Care for Section 232 Residential Care Facilities Is Limited

FHA requires field office officials, when processing applications for Section 232 mortgage insurance from existing state-licensed facilities to review the most recent annual state-administered inspection report for the facilities, but does not require the continued monitoring of annual inspection reports for state-licensed facilities once it has insured them. Four of the five HUD field offices we visited do not routinely collect annual inspection reports for the insured facilities they oversee. While such reports are but one of several means of monitoring insured properties, FHA's limited use of them may lead the agency to overlook potential indicators of risk for some of its insured loans.

FHA Requires Some Coordination with States' Oversight of Quality of Care for Section 232 Residential Care Facilities

State inspections or surveys of residential care facilities may stem from state licensing requirements or the facilities' participation in Medicare or Medicaid. Nursing homes are state licensed, while states vary in their licensing requirements for assisted living facilities. The Department of Health and Human Services' Centers for Medicare & Medicaid Services requires that nursing homes receiving Medicare and Medicaid funding be federally certified, and all certified facilities are subject to annual federal inspections administered by the states. State survey agencies, under agreements between the states and the Secretary of Health and Human Services, conduct the annual federally required inspections. To complete the annual inspections, teams of state surveyors visit Medicare and Medicaid participating facilities and assess compliance with federal facility requirements, particularly whether care and services provided meet the assessed needs of the residents. These teams also assess the quality of care provided to residents of the facilities, looking at indicators such as preventing avoidable pressure sores, weight loss, or accidents. Overall, annual inspections provide a regular review of quality of care by officials with relevant backgrounds, such as, registered nurses, social workers, dieticians, and other specialists. For facilities that are applying for mortgage insurance under the Section 232 program, FHA requires a copy of the state license needed to operate the facility and a copy of the latest state annual inspection report on the facilities' operation.

HUD's "Multifamily Asset Management and Servicing Handbook" recommends that, once nursing home loans are insured under the program, HUD officials responsible for loan monitoring continue to review state annual inspection reports if they do not undertake management reviews of the facility. Management reviews focus on an insured facility's financial indicators and general management practices, but, particularly if conducted on-site, could provide some information on issues related to the quality of care at a facility. Because of their wider scope, however, management reviews would not likely go into the same depth on quality of care issues as annual inspections. HUD headquarters officials told us that the handbook's recommendation applies to all Section 232 facilities; further, HUD headquarters officials stated that management reviews for Section 232 properties should be conducted based on need and available resources. We found that two of five field offices we visited did not regularly conduct any regular management reviews and did not review annual inspection reports during loan monitoring. Of the three field offices that did conduct management reviews on some Section 232 properties, one also reviewed annual inspection reports during loan monitoring. Additionally, the offices that did not review annual inspection reports had little direct interaction with the state agencies. Private lenders overseeing non-FHA insured residential care facilities told us that they regularly conduct various levels of management reviews and review annual inspection reports on a consistent basis.

FHA has emphasized the importance of ongoing coordination with state oversight agencies in its proposed revisions to its regulatory agreements, which require owners or operators of insured facilities to report any state or federal violations to FHA. HUD's proposed revisions to the regulatory agreements also include a requirement that the owner or operator provide HUD with copies of annual inspection reports that can be used as part of loan monitoring. However, the proposed revisions to the regulatory agreements have yet to be approved.

FHA's Limited Coordination with States on Oversight Issues May Lead to Missed Identification of Risk Indicators

Serious quality of care deficiencies can have a variety of implications that affect cash flow streams, ranging from a related reduction in occupancy to the potential for civil money penalties and loss of licensing and reimbursements. Consequently, quality of care concerns can ultimately affect a facility's financial condition. For many Section 232 properties, in particular nursing homes, state oversight of quality of care helps to determine whether a facility is licensed and eligible to receive Medicaid and Medicare reimbursements. This is particularly important to the Section

232 program because, as noted earlier in this report, Medicaid and Medicare reimbursements typically account for a significant portion of nursing home income.

Federal or state annual inspection reports, to the extent that they are available for facilities, provide regular evaluations of nursing homes and other residential care facilities. As discussed earlier, annual inspections provide a review of quality of care by officials with relevant backgrounds. In a 2005 report, we found inconsistencies across states in conducting surveys and state surveyors understating serious deficiencies in quality of care.[17] Nonetheless, annual inspection reports serve as an important indicator of a property's risk related to problems with the quality of care to residents.

Annual inspection reports, coupled with other information such as facility staffing profiles, resident turnover, and data from financial statements, could assist HUD's field offices in overseeing loan performance. Additionally, reviewing facilities' quality of care records over time, as well as any corrective action plans needed to come into compliance with state and federal quality of care requirements could further the field offices' ability to identify loan performance risks. The reports may also prompt HUD field office officials to communicate with federal or state nursing home regulatory agencies for further information on facilities that appear to be high risk. These agencies may have available information on civil money penalties and sanctions, which serve as additional indicators of quality of care risk. Private lenders we spoke with acknowledged that annual inspection reports provided insight into the management of a facility and coupled with other information could help to assess financial risk.

Program and Industry Trends Show Sources of Potential Risks to the GI/SRI Fund

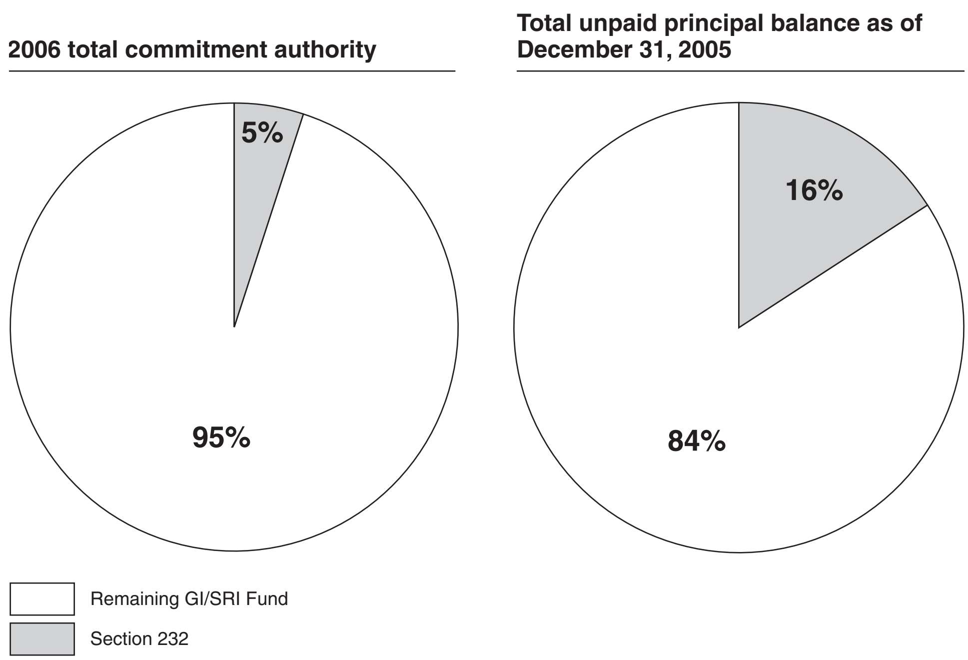
The Section 232 program represents a relatively small share of the broader GI/ SRI Fund. However, program and industry trends show sources of potential risks that could affect the future performance of the Section 232 portfolio and the GI/SRI Fund. FHA uses a number of tools to mitigate risk to the program and to the fund.

[17]See GAO-06-117, 4.

The Section 232 Program Represents a Small Percentage of the GI/SRI Fund

The Section 232 program is a relatively small share of the total GI/SRI Fund. HUD estimated that the program would represent only about 5.3 percent of the fund's fiscal year 2006 commitment authority.[18] Similarly, the Section 232 program represents a little less than 16 percent or a little more than $12.5 billion of the nearly $80 billion in unpaid principle balance in the GI/SRI Fund (see fig. 1). Despite its small size, a significant worsening in the performance of the Section 232 program could negatively affect the performance of the GI/SRI Fund. The extent, though, of the impact on the overall performance of the GI/SRI Fund would depend upon numerous factors including changes in the size and performance of the other programs in the fund.

Figure 1: The Section 232 Program Comprises a Relatively Small Part of the GI/SRI Fund



Source: GAO analysis of HUD fiscal year 2006 budget and data from F47 (a HUD multifamily housing database) as of December 31, 2005.

Note: Numbers have been rounded to closest whole number.

[18]The GI/SRI Fund's commitment authority represents the maximum aggregate amount of loans that can be guaranteed under the programs in the fund.

Program Trends Show Sources of Potential Risk

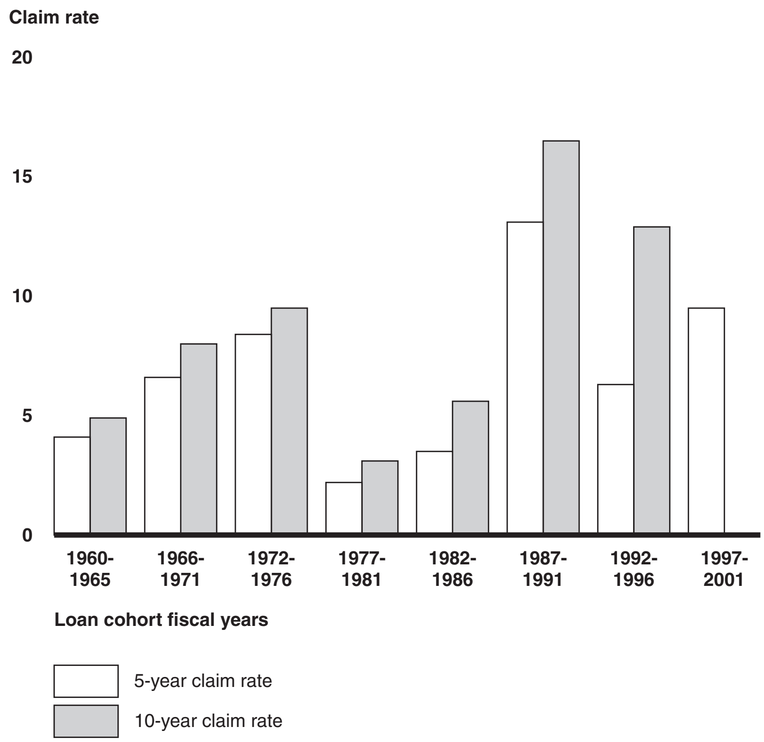
As discussed below, several trends exist within the Section 232 program that pose potential risks to the Section 232 portfolio and, therefore, to the GI/SRI Fund.

Higher Claim Rates for Recent Loan Cohorts

To identify potential trends in loan performance, we analyzed 5- and 10-year claim rates for Section 232 loans based on data that spanned from fiscal year 1960 through the end of fiscal year 2005, for the entire portfolio, as well as by type of loan purpose and type of insured facility. The analysis of the entire portfolio showed that the 10-year claim rates for more recent loan cohorts (loans originated between 1987 and 1991 and loans originated between 1992 and 1996) ranked among the highest historical cohort claim rates (see fig. 2).[19] The 5-year claim rate for loans originated between 1997 and 2001 also ranked among the highest historical cohort claim rates. A continued increase in claim rates could have a negative effect on the performance of the GI/SRI Fund.

[19]In our analysis of Section 232 loan data, we grouped loans into cohorts (loans originated in a given fiscal year) of approximately 5 fiscal years of loans. This was done to allow for a more meaningful analysis given the small number of Section 232 loans endorsed per fiscal year. We analyzed 5- and 10-year claim and prepayment rates because more claims and prepayments take place within 10 years of loan endorsement.

Figure 2: Overall 5- and 10-Year Claim Rates for the Most Recent Cohorts of the Section 232 Program Are Among the Highest Historical Claim Rates



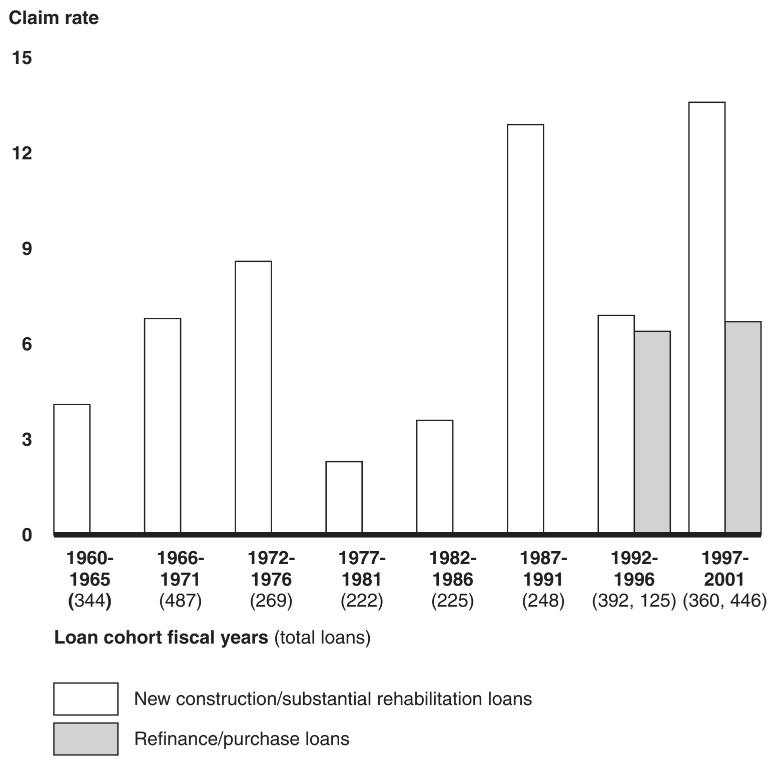
Source: GAO analysis of data from F47 (a HUD multifamily housing database) as of the end of fiscal year 2005.

Changes in Claim Rates by Loan Purpose

Section 232 loans can have a loan purpose in one of two categories—new construction/substantial rehabilitation loans or refinance/purchase loans. New construction loans are for loans that involve the construction of a new residential care facility. Substantial rehabilitation loans are for loans that meet HUD criteria for substantial rehabilitation of a residential care facility, such as two or more building components being substantially replaced. Purchase loans are for loans in which the borrower is acquiring an existing residential care facility, while refinance loans are the refinancing of an existing HUD insured loan or a loan not previously insured by HUD. As described earlier in the report, HUD began to allow for the refinancing of FHA-insured facilities and non-FHA insured facilities in 1987 and 1994, respectively. When analyzing Section 232 loan data by loan purpose, we found that new construction/substantial rehabilitation loans have a higher 5-year claim rate than refinance/purchase loans for the most recent cohort for which data are available (see fig. 3).[20] New construction/substantial rehabilitation loans originated between 1997 and 2001 also have the highest historical 5-year cohort claim rate for these type of loans. Because of the higher claim rates in recent years, continued monitoring will be important. In contrast, the number of refinance and purchase loans endorsed in the last 5 years is more than double those endorsed in the previous 5 years. The future impact of the refinance and purchase loans on the overall performance of the Section 232 program is uncertain since they have existed for a shorter period of time and thus there is currently limited data available to assess the relative risk of claims.

[20]We are reporting 5-year claim rates rather than 10-year claim rates when comparing refinance loans because HUD insured its first refinance loans in 1992. As a result, there are limited data available for 10-year claim rates.

Figure 3: The 5-Year Claim Rate for New Construction Loans Has Increased in the Most Recent Cohort for Which Claim Rate Data Are Available



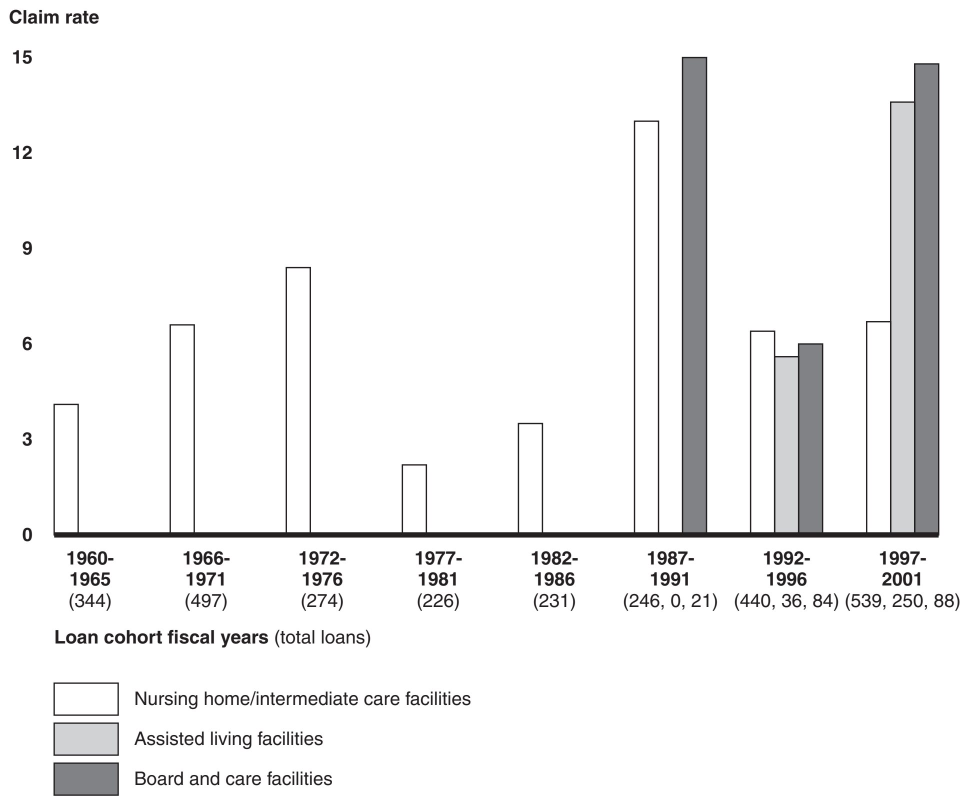
Source: GAO analysis of data from F47 (a HUD multifamily housing database) as of the end of fiscal year 2005.

Changes in Claim Rates by Facility Type

As discussed earlier in the report, HUD insures different types of residential care facilities that include nursing homes, intermediate care facilities, assisted living facilities, and board and care facilities. Assisted living facilities are relatively new to the portfolio, and the number of these loans have been increasing. Our analysis of Section 232 loan data by facility type found that board and care facilities had a slightly higher 10-year claim rate than nursing home facilities in the most recent cohorts; however, these loans remain a very small percentage of the active portfolio and are being made in decreasing numbers. There are limited data to observe claim trends on assisted living facilities, making their risk difficult to assess, but the 5-year claim rates for assisted living facilities have increased significantly in the most recent cohort years for which claim rate data are available (see fig. 4). A continued high claim rate in assisted living facilities could negatively affect the performance of the Section 232 program and the

GI/SRI Fund. However, lenders and HUD officials told us that, although assisted living facilities had high claim rates in the past, they believe the market has stabilized and lessons have been learned.

Figure 4: The 5-Year Claim Rates for Assisted Living and Board and Care Facilities Have Increased in the Most Recent Cohorts for Which Claim Rate Data Are Available



Source: GAO analysis of data from F47 (a HUD multifamily housing database) as of the end of fiscal year 2005.

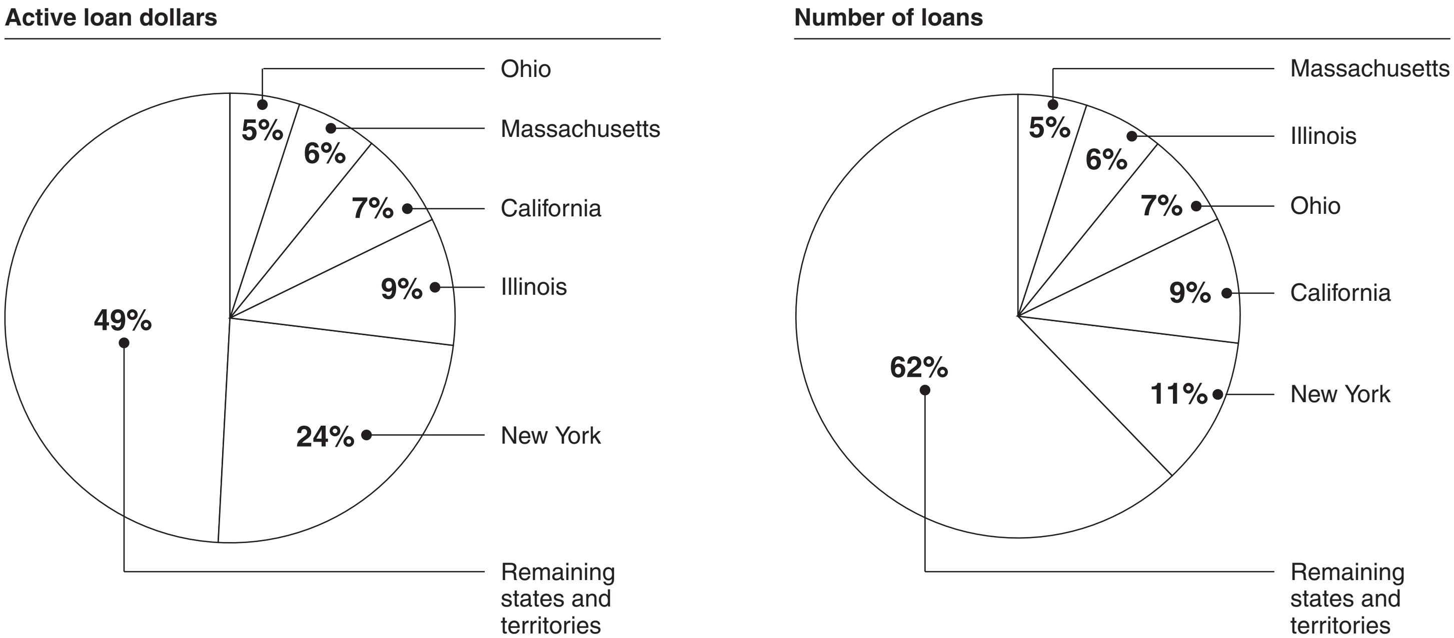
Increase in Loan Prepayments

Another observable trend is the increase in the portion of loans in each cohort that is prepaid. (Prepayment occurs when a borrower pays a loan in full before the loan reaches maturity.) There have been 1,688 prepayments in the Section 232 program from 1960 through the end of fiscal year 2005 and loans that terminate do so overwhelmingly because of prepayment. Moreover, the proportion of loans that terminate due to prepayment within 10 years of origination is increasing. Specifically, the 10-year prepayment rates for the three most recent cohorts for which 10-year claim rates are available are more than double that of some earlier cohorts. As more borrowers prepay their loans, HUD loses future cash flows from premiums; thus, higher prepayment rates will likely make the net present value of cash flows decrease. However, the decrease could be offset to the extent that higher prepayment rates result in fewer claims (a prepaid loan cannot result in a claim).

Concentration of Loans

Market concentration also poses some risks to the GI/SRI Fund. The Section 232 program is concentrated in several large markets and in loans made by relatively few lenders. As of 2005, five states (California, Illinois, Massachusetts, New York, and Ohio) held 51 percent of active Section 232 loan dollars and 38 percent of active loan properties (see fig. 5). New York holds close to 24 percent of the active loan dollars in the portfolio. This is an improvement since 1995 when we found that eight states accounted for 70 percent of the portfolio, and New York accounted for 32 percent of the portfolio. However, the current market concentration could still pose risk to the portfolio if a sudden market change took place in one or more of the states with a larger percentage of the insured Section 232 loans. We also found significant loan concentration among a small group of lenders. While a total of 109 lenders held active loans, 6 hold over half of the active loan portfolio. GMAC Commercial Mortgage Corporation holds more than 17 percent of all active mortgages in the Section 232 program, the single largest share of any lender. This concentration among lenders potentially makes the program more vulnerable if one or a few large lenders encounter financial difficulty.

Figure 5: Section 232 Properties Are Concentrated in Several States



Source: GAO analysis of data from F47 (a HUD multifamily housing database).

Note: Active loan dollars are from F47 as of the end of calendar year 2005, and number of loans are from F47 as of the end of fiscal year 2005. This also does not include one loan for which property state information was not available in F47. Numbers have been rounded to closest whole number.

Industry Faces Uncertainties

The Section 232 program may also face risks from trends in the residential care industry at large that include uncertainty about sources of revenue and occupancy. Nursing home revenue is generated in large part from the Medicare and Medicaid programs, which make up 58 percent of national nursing home spending. Private lenders we interviewed that offer non-FHA-insured residential care facility loans explained that one of the primary reasons their loans are shorter-term loans than those of HUD is due to their perception of the potential, long-term uncertainty in the funding of the Medicaid and Medicare programs, which generally account for a large share of patient payments in nursing homes. We and others have reported that Medicare and Medicaid spending may not be sustainable at current levels.[21] In our 2003 report on the impact of fiscal pressures on state reimbursement rates, however, we found that even in states that recently faced fiscal pressures, reimbursement rates remained largely unaffected.[22] At that time, we concluded that any future changes to state reimbursement rates remain uncertain. If program cuts occur in federal spending on Medicaid that result in shifting costs from the federal government to state governments, states could contain costs by taking a number of steps, including freezing or reducing reimbursement rates to providers. An ongoing tension exists, however, between what federal and state governments and the nursing home industry believe to be reasonable Medicare and Medicaid reimbursement rates to operate efficient and economic facilities that provide quality care to public beneficiaries. As the federal and state governments face growing long-term financial pressure on their budgets, these budgetary pressures may have some spillover effects on Medicare and Medicaid revenue streams for the nursing home industry.

Uncertainty also exists about the future demand for residential care facilities and the corresponding effects on occupancy. As the number of Americans aged 65 and older increases at a rapid pace, lenders we interviewed projected an increased need for residential care facilities.[23] Industry officials also noted a rise in alternatives to nursing home care, such as assisted living facilities and home and community-based care options. As patients choose alternative care options, traditional nursing homes may face occupancy challenges. Overall, these changes to the nursing home facilities patient base may lower occupancy and income levels for nursing homes, including those in the Section 232 portfolio. However, these changes may positively affect the occupancy and income levels of other types of residential care facilities, including those in the Section 232 portfolio.

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[21]GAO, *21st Century: Reexaming the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.; Feb. 1, 2005), 33-35; GAO, *Long-Term Care Financing: Growing Demand and Cost of Services Are Straining Federal and State Budgets*, GAO-05-564T (Washington, D.C.; Apr. 27, 2005), 7; Fitch Ratings, 2*005 Non-Profit Hospitals and Health Care Systems Forecast* (New York, NY: Jan. 20, 2005), 8.

[22]GAO-04-143, 3.

[23]GAO, *Aging Issues: Related GAO Products in Calendar Years 2001 and 2002*, GAO-04-275R (Washington, D.C.: Nov. 21, 2003), 1.

FHA Uses a Number of Tools to Mitigate Risks

As described elsewhere in this report, FHA uses a number of tools to mitigate risks to the program and to the GI/SRI Fund. These tools include imposing requirements prior to insuring loans to help prevent riskier loans from entering the Section 232 portfolio. FHA also uses various tools—such as reports on physical inspections of facilities, and financial and other information captured in data systems—to monitor the status of insured facilities and the performance of their loans. Additionally, FHA officials use quality control reviews to mitigate the risk for the program as a whole using two processes: Quality Management Reviews and Lender Qualifications and Monitoring Division reviews (the latter reviews are described in app. II).

HUD's Model for Estimating Credit Subsidy Costs Excludes Some Potentially Relevant Factors

HUD's model for estimating annual credit subsidies—which incorporates assessments of various risks that loan cohorts will face and includes assumptions consistent with the Office of Management and Budget (OMB) guidance—does not explicitly consider the impacts of some potentially important factors. These factors include: variables to capture the impact of prepayment penalties or restrictions on prepayments, the loan-to-value ratio and debt service coverage ratios of Section 232 properties at the time of loan origination and differences between types of residential care facilities. Further, the model does not fully capture the effects on existing loans to changes in market interest rates, and it uses proxy data that are not comparable to the loans in the Section 232 program. As a result, HUD's model for estimating the program's credit subsidy may result in over- or underestimation of costs.

HUD Uses a Model to Estimate Credit Subsidy Costs

Federal law requires HUD to estimate a credit subsidy for its loan guarantees. The credit subsidy cost is the estimated long-term cost to the government of a loan guarantee calculated on a net present value basis and excluding administrative costs. HUD estimates a credit subsidy for each loan cohort. This estimate reflects HUD's assessment of various risks, based in part on the performance of loans already insured. Since 2000, HUD has annually estimated two credit subsidy rates for the Section 232 program, reflecting its two largest risk categories: loans for new construction and substantial rehabilitation, and loans for refinance and purchase loans.[24] HUD uses an identical methodology for each estimate.

To estimate the initial subsidy cost of the Section 232 program, HUD uses a cash flow model to project the cash flows for all identified loans over their expected life. The cash flow model incorporates regression models and uses assumptions based on historical and projected data to estimate the amount and timing of claims, subsequent recoveries from these claims, prepayments, and premiums and fees paid by the borrower. The regression models incorporate various economic variables such as changes in GDP, unemployment rate, and 10-year bond rates. The model also has broken out claim and prepayment data into new construction and refinance loans since these loans are expected to perform differently.

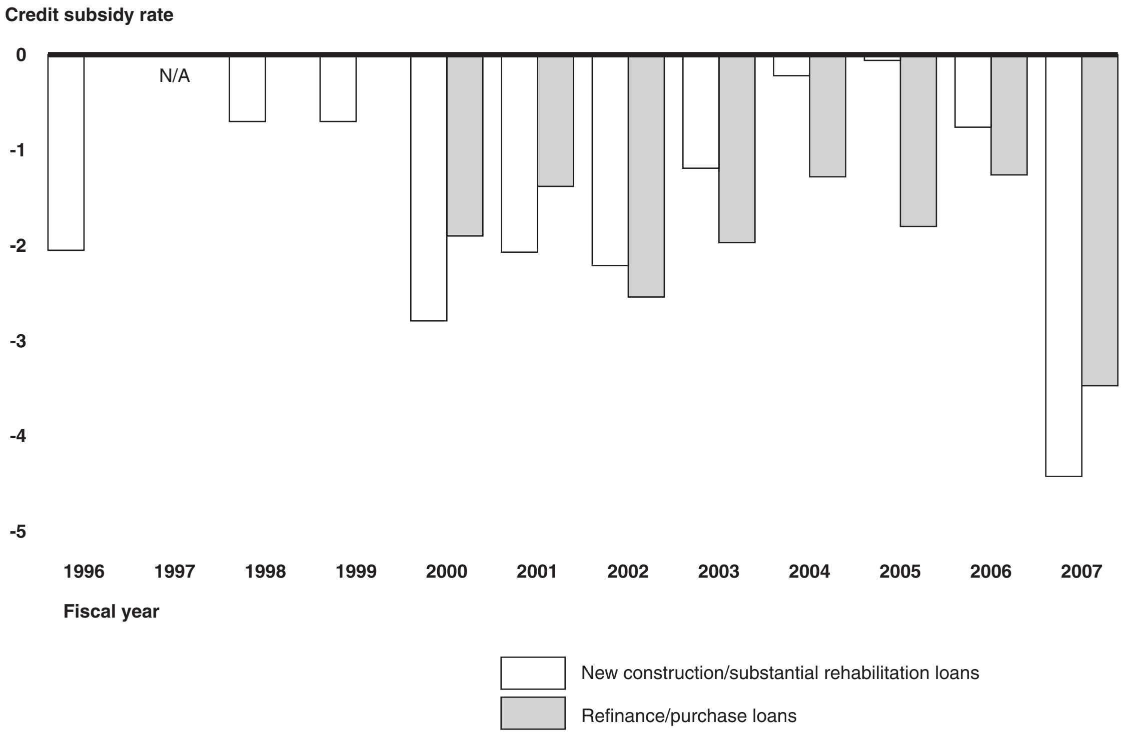
HUD inputs its estimated cash flows into OMB's credit subsidy calculator, which calculates the present value of the cash flows and produces the official credit subsidy rate. A positive credit subsidy rate means that the present value of cash outflows is greater than inflows, and a negative credit subsidy rate means that the present value of cash inflows is greater than cash outflows. For the Section 232 program, cash inflows include premiums and fees, servicing and repayment income from notes held in inventory, rental income from properties held in inventory, and sale income from notes and properties sold from inventory. Cash outflows include claim payments and expenses related to properties held in inventory.

Since HUD began estimating the initial subsidy cost of the Section 232 program, it has estimated that the present value of cash inflows would exceed the outflows. As a result, the initial credit subsidy rates for the Section 232 program were negative. However, estimates from more recent years showed that the negative subsidy rates on new construction and substantial rehabilitation loans have generally been shrinking, meaning that the projected difference between the program's cash inflows and cash outflows was decreasing. In HUD's most recent estimate (for the fiscal year 2007 cohort), the estimated cash inflows exceed the estimated cash outflows by a considerably greater margin than in any previous year's estimate. This may reflect increased premiums for Section 232 loans; the President's proposed budget for fiscal year 2007 specifies increases in

[24]For purposes of tracking Section 232 loans in its databases, HUD groups together refinance and purchase loans. Similarly, it also groups together new construction and substantial rehabilitation loans.

mortgage insurance premiums for almost all FHA programs, including increasing the rate for Section 232 refinance and new construction loans to 80 basis points from 57 basis points. Figure 6 shows changes in the initial estimated credit subsidy rate over time for both loan categories.

Figure 6: Initial Credit Subsidy Estimates for Section 232 Program New Construction and Substantial Rehabilitation Loans and for Section 232 Program Refinance and Purchase Loans Have Not Indicated a Need for Subsidies



Source: GAO analysis of OMB federal credit supplement data (1996-2007).

Note: Initial credit subsidy estimates were not available for 1997 for new construction and substantial rehabilitation loans and for 1996-1999 for refinance and purchase loans.

Features of the Credit Subsidy Model May Lead to Unreliable Credit Subsidy Estimates

HUD's model for estimating credit subsidy rates incorporates numerous variables, but the model's exclusion of potentially relevant factors and its use of proxy data from another FHA loan program may negatively affect the quality of the estimates. Including additional information in the model could enhance the predictive value of the model.

Prepayment Penalties or Restrictions

According to some economic studies, prepayment penalties, or penalties associated with the payment of a loan before its maturity date, can significantly affect borrowers' prepayment patterns.[25] This is also important for claims, since if a loan is prepaid it can no longer go to claim. HUD's model does not explicitly consider the potential impact of prepayment penalties or restrictions, even though they can influence the timing of prepayments and claims and collections of premiums. According to FHA officials, FHA does not place prepayment penalties on FHA-insured nursing home loans. However, according to the Section 232 program's regulations, a lender can impose a prepayment penalty charge and place a prepayment restriction on the mortgage's term, amount, and conditions.[26] We reviewed a sample of Section 232 loans and found that prepayment penalties and restrictions were consistently applied to these loans.[27]

According to FHA officials and mortgage bankers, prepayment restrictions on Section 232 loans typically range from 2 to 10 years of prepayment restrictions and 2 to 8 years of prepayment penalties. While FHA does not specifically maintain data on insured residential care facility financing terms, prepayment restrictions are specified on the mortgage note, which is available to FHA. Incorporation of such data into the Section 232 program's credit subsidy rate model could refine HUD's credit subsidy estimate by enhancing the model's ability to account for estimated changes in cash flows as a result of prepayment restrictions.

According to HUD officials responsible for HUD's cash flow model, prepayment penalties and restrictions are not incorporated into the model because HUD does not collect such data. HUD officials added that even though the cash flow model does not explicitly account for prepayment penalties and restrictions, its use of historic data implicitly captures trends that may occur as a result of prepayment penalties and restrictions. The

[25]Jesse M. Abraham and H. Scott Theobald, "A Simple Prepayment Model of Commercial Mortgages," *Journal of Housing Economics*, vol. 6 no. 1, (1997); Austin Kelly; V. Carlos Slawson, Jr., "Time-Varying Mortgage Prepayment Penalties," *Journal of Real Estate Finance and Economics*, vol. 23, no. 2, (2001); Qiang Fu, Michael LaCour-Little, and Kerry D. Vandell, "Commercial Mortgage Prepayments Under Heterogeneous Prepayment Penalty Structures," vol. 25, no. 3 (2003).

[26]The regulations also state that prepayment restrictions and penalty charges must be acceptable to the FHA Commissioner.

[27]We analyzed prepayment restrictions from the mortgage notes of 32 projects with loan payments beginning in 2001 to 2005.

model's projections are influenced by the average level of prepayment protection in the historical data but not by the trend. If prepayment penalties and other restrictions have changed over time in the past, or change in the future, then not incorporating this information could lead to less reliable estimates.

Debt Service Coverage Ratio at Point of Loan Origination

Initial debt service coverage ratios are another important factor that may affect cash flows, as loans with lower initial debt service coverage ratios may be more likely to default and result in a claim payment. HUD's cash flow model does not consider the initial debt service coverage ratio of Section 232 loans at the point of loan origination. By initial debt service coverage ratio, we are referring to the projected debt service coverage ratio that is considered during loan underwriting. According to the HUD official responsible for HUD's cash flow model, the initial debt service coverage ratio of a residential care facility is not included as a part of the cash flow model because it (1) is not a cash flow, (2) does not vary, and (3) has no predictive value. We agree that a debt service coverage ratio is not a cash flow. However, initial debt service coverage ratios potentially affect relevant cash flows, as do other factors that are included in HUD's model but are also not cash flows to HUD, such as prepayments. For example, the model considers estimated prepayments because they potentially affect future cash inflows from fees and future cash outflows from claim payments.

Our analysis of available projected debt service coverage ratios, which include the amount of new debt being insured, shows that these ratios varied from 1.1 to 3.6.[28] All other factors being equal, loans with debt service coverage ratios of 3.6 are generally considered to have less risk than a loan with only a 1.1 debt service coverage ratio.

Economic theory suggests that the debt service coverage ratio is an important factor in commercial mortgage defaults. However, empirical studies show mixed results regarding the significance of the impact of debt service coverage ratios upon commercial mortgage defaults. Some studies indicate that debt service coverage ratios are meaningful factors in modeling default risk and are helpful in predicting commercial mortgage

[28]We analyzed debt service coverage ratios from the underwriting reports of 42 projects that applied for mortgage insurance between fiscal years 2000 and 2006.

terminations.[29] Other studies find initial debt service coverage ratios to be statistically insignificant in modeling commercial mortgage defaults.[30] These mixed results may be the consequence of relatively small sample sizes and model specification issues.

Loan-to-Value Ratio at Point of Loan Origination

Initial loan-to-value ratios are another important factor that may affect cash flows, as loans with higher initial loan-to-value ratios may be more likely to default and result in a claim payment. By initial loan-to-value ratio, we are referring to the projected loan-to-value ratio that is considered during loan underwriting. HUD's cash flow model also does not consider the initial loan-to-value ratio of Section 232 loans at the point of loan origination.

According to the HUD official responsible for HUD's cash flow model, the initial loan-to-value ratio of a Section 232 property is not included as a part of the cash flow model because it does not vary and has no predictive value. However, our analysis of available projected loan-to-value ratios, which include the amount of new debt being insured, shows that these ratios varied from 66 percent to 95 percent.[31] All other factors being equal, loans with loan-to-value ratios of 66 percent are generally considered to have less risk than a loan with only a 95 percent loan-to-value ratio. While economic theory suggests that the loan-to-value ratio is an important factor in commercial mortgage defaults, empirical studies show mixed results regarding its significance. Some studies indicate that loan-to-value ratios are meaningful factors in modeling default risk and are helpful in predicting

[29]Athanasios Episcopos, Andreas Pericli, and Jianxun Hu, "Commercial Mortgage Default: A Comparison of Logit with Radial Basis Function Networks," *Journal of Real Estate Finance and Economics*, vol. 17, no. 2, (1998); and Wayne R. Archer, Peter J. Elmer, David M. Harrison, and David C. Ling, "Determinants of Multifamily Mortgage Default," *Real Estate Economics*, vol. 30, no. 3 (2002).

[30]Brian A. Cochetti, Honeying Deng, Bin Gao, and Rui Yao, "The Termination of Commercial Mortgage Contracts Through Prepayment and Default: A Proportional Hazard Approach with Competing Risks," *Real Estate Economics*; vol. 30, no. 4 (2002); Kerry D. Vandell, Walter Barnes, David Hartzell, Dennis Kraft, and William Wendt, "Commercial Mortgage Defaults: Proportional Hazards Estimation Using Individual Loan Histories," *Journal of the American Real Estate and Urban Economics Association*, vol. 21, no. 4 (1993).

[31]We analyzed loan-to-value ratios from the underwriting reports of 42 projects that applied for mortgage insurance between fiscal years 2000 and 2006.

commercial mortgage terminations.[32] Other studies find initial loan-to-value ratios to be statistically insignificant in modeling commercial mortgage defaults.[33] These mixed results may be the consequence of relatively small sample sizes and model specification issues.

Types of Facilities Insured and Changes in Interest Rates

The model's ability to reliably forecast claim rates may be enhanced by incorporating a variable indicating facility type into the regression analysis. HUD's cash flow model does not explicitly consider differences in loan performance between types of facilities, such as nursing homes, assisted living facilities, and board and care facilities. However, when looking at the most recent cohorts for which 5-year claim rates are available, our analysis found the 5-year claim rates for assisted living facilities to be significantly higher than the 5-year claim rates for nursing homes (6.7 percent 5-year claim rate for nursing homes versus 13.6 percent for assisted living facilities).

In addition, we found that HUD's cash flow model generally incorporates the interest rate on the individual loans (the contract rate) and the prevailing market interest rate (captured by the 10-year bond rate) as separate variables. Economic theory suggests, when modeling mortgage terminations, that considering these two variables jointly as a single variable in the form of a ratio is the best way to capture the effects on existing loans when market interest rates change.[34] For example, if market rates fall below the contract rate on existing Section 232 loans, then it may become more attractive for borrowers to prepay. However, if market rates

[32]Y. Deng, J. Quigley, and A. Sanders, "Commercial Mortgage Terminations: Evidence from CMBS," University of Southern California (2004); Athanasios Episcopos, Andreas Pericli, and Jianxun Hu, "Commercial Mortgage Default: A Comparison of Logit with Radial Basis Function Networks," *Journal of Real Estate Finance and Economics* vol. 17, no. 2, (1998); and Office of Federal Housing Enterprise Oversight, "Risk-Based Capital Regulation: Second Notice of Proposed Rulemaking," *Federal Register* 64 (1999).

[33]Wayne R. Archer, Peter J. Elmer, David M. Harrison, and David C. Ling, "Determinants of Multifamily Mortgage Default," *Real Estate Economics*, vol. 30, no. 3 (2002); B. Ambrose and A. Sanders, "Commercial Mortgage-Backed Securities: Prepayment and Default," *Journal of Real Estate Finance and Economics*, vol. 26, no. 2 and 3.

[34]Scott Richard and Richard Roll, "Prepayments on Fixed-rate Mortgage-backed Securities," *Journal of Portfolio Management*, Spring 1989. Additionally, we found other studies which include market rate and contract rate as a ratio in the modeling of mortgage terminations. These studies include B. Ambrose and A. Sanders, "Commercial Mortgage-Backed Securities: Prepayment and Default," *Journal of Real Estate Finance and Economics*, vol. 26, no. 2 and 3; and Qiang Fu, Michael LaCour-Little, and Kerry D. Vandell, "Commercial Mortgage Prepayments Under Heterogeneous Prepayment Penalty Structures," 25, 3 (2003).

fall but remain above the contract rates, then it may not become more attractive for borrowers to prepay. Using a ratio captures the distinction between these two examples because it considers the relative cost to the borrower of the mortgage given the contract rate, as compared to the mortgage with the market interest rate. By generally considering the contract rate and market interest rate separately, HUD potentially loses the ability to capture this distinction and predict large responses when market rates fall and small responses when market rates rise.[35]

Use of Proxy Data

HUD's use of Section 207 loans as a proxy for Section 232 refinance loans could lead to less reliable credit subsidy estimates for the Section 232 program. HUD uses certain Section 207 loans—refinance loans for existing multifamily housing properties—as proxy data for the claim regression for Section 232 refinance loans. The Section 207 loans are not residential health care facility loans. According to HUD officials, HUD uses the Section 207 loans because there are insufficient data on Section 232 refinance loans. A HUD official told us that Section 207 loans were selected as proxy data because they are refinance loans and because they have similar performance to the Section 232 refinance loans, as indicated by the cumulative claim rates they calculated.

Consideration of the basis for using proxy data is important. When using the experience of another agency or a private lender as a proxy, the Federal Accounting Standards Advisory Board (FASAB) suggests that an agency explain why this experience is applicable to the agency's credit program and examine possible biases for which an adjustment is needed, such as different borrower characteristics.[36] HUD could reasonably be expected to follow the FASAB guidance when using data from a different program at HUD. HUD told us that they did not compare borrower characteristics for Section 207 loans and Section 232 loans. A HUD official told us that HUD agreed that they would not expect borrowers of Section 207 loans to have similar characteristics to borrowers of Section 232 loans.

[35]One of HUD's regressions calculates the difference between contract rates and market rates. Considering the difference between the contract rate and the market rate is better than considering the rates separately, but is still not as strong an approximation as using a ratio. See Richard and Roll.

[36]FASAB is responsible for promulgating accounting standards for the U.S. government, and these standards are recognized as generally accepted accounting principles for the federal government. FASAB developed standards for agencies regarding the basis for supporting cash flow assumptions for loan guarantee programs.

HUD analyzed the comparability of Section 207 and Section 232 refinance loans using cumulative claim rate analysis, but we question the methodology the agency used to make this comparison. Additionally, we compared the refinance loans for each of the programs by calculating conditional claim and prepayment rates as well as 5-year cumulative claim and prepayment rates, and we found significant differences between the programs (see app. IV for a further description of HUD's methodology and our comparison of the two programs).

We question HUD's use of Section 207 loans as a proxy for Section 232 loans, given the differences we observed. We cannot fully estimate the overall impact on the credit subsidy estimate, and the effects of the claim and prepayment rates could partially offset each other. The higher prepayment rates for Section 207 loans could lead to HUD underestimating future revenues for Section 232 loans (HUD would project that many of these loans would terminate, although they would actually remain active and pay premium revenue to HUD.) The lower claim rates on Section 207 loans could result in HUD estimating that fewer of its Section 232 loans would result in a claim and thus lead it to underestimate future costs.

In the future, more data will be available on the actual performance of Section 232 refinance loans that can be used in estimating credit subsidy needs. To avoid using questionable proxy data in the interim, one possible approach, among others, would be to use a simpler estimation method, such as using average claim and prepayment rates over time as is done in estimating credit subsidy rates for the Section 242 Hospital Mortgage Insurance program.

Conclusions

The Section 232 program is the only source of mortgage insurance for residential care facilities. Accordingly, it is important to ensure good program and risk management practices. While some field offices we visited had adopted practices to better manage risks of their Section 232 loans, varying awareness of program requirements and insufficient levels of staff expertise contribute to increased financial risk in the Section 232 program loan portfolio and thus the GI/SRI Fund. HUD has numerous underwriting and monitoring guidelines and policies to manage the risks of Section 232 loans. However, to the extent that field office staff do not accurately implement current underwriting and monitoring guidelines and policies, they potentially allow loans with unwarranted risks to enter the portfolio and may miss opportunities to identify problems with already-insured loans early enough to help prevent claims. Revising the

"Multifamily Asset Management and Project Servicing Handbook" to include monitoring requirements specific to the Section 232 program, as the Office of Inspector General noted in its 2002 report, would help in this regard. So too would the sharing of additional practices, such as involving asset management staff in the underwriting process, undertaken by some field offices to better manage risks in their program loans. Moreover, adequately training staff to develop expertise on residential care loans and industry could help assure proper underwriting and oversight of Section 232 loans, which tend to be more complex than those in other HUD multifamily programs. Field office officials' concerns about their existing levels of staff expertise heighten the need for appropriate guidance and additional training specific to the Section 232 program, while the potential loss of specialized staff within the next 5 years underscores the need for HUD, in the context of its strategic human capital efforts, to assure adequate program expertise in the future.

Although HUD recommends that field offices obtain and review annual inspection reports for licensed facilities insured by the program, four of five offices we visited did not do so. By not routinely using, in combination with other performance indicators, the results of annual inspection reports on insured facilities subject to such inspections, HUD may be missing important indicators of problems that could result in claims that might otherwise have been prevented. Reviewing inspection reports is also a means of obtaining relevant information about insured facilities that have not been the subject of FHA management reviews. HUD's long-proposed revisions to its residential care facility regulatory agreement recognize the potential usefulness of information on state-administered inspections by requiring that owners or operators report inspection violations and supply HUD with copies of annual inspection reports. The proposed revisions would also address a number of the internal control weaknesses identified by the HUD Inspector General's 2002 report, but it remains unclear when the proposed revisions will be approved, leaving the program exposed to identified weaknesses in the interim.

While the Section 232 program represents a relatively small portion of the GI/SRI Fund, it faces risks that could affect the performance of the loan portfolio and the fund. HUD uses a number of tools to mitigate risks, and it will be important to continue monitoring program trends and industry developments. Recent increases in the numbers of assisted living facility loans and refinance loans are a source of uncertainty, in that there is as yet little data with which to assess their long-term performance. Similarly, industry trends and the availability of future Medicaid and Medicare funds are sources of uncertainty, and heighten the need for HUD to have sufficient staff expertise with which to monitor future developments that could affect the program and ultimately the GI/SRI Fund.

HUD's model for estimating the program's credit subsidy incorporates assessments of various risks that loan cohorts face, but it does not explicitly consider certain factors that could result in over- or underestimation of costs. These factors include prepayment penalties, lockout provisions, facility type, loan-to-value ratio, the debt service coverage ratio of loans at commitment, and the ratio of contract rates to markets rates, which some economic studies suggest are potentially useful in modeling risks. Including such factors could enhance the credit subsidy estimates and provide HUD and the Congress with better cost data with which to assess the program. Additionally, HUD's use of Section 207 refinance loans, which we do not find to be a good proxy for Section 232 refinance loans, could specifically contribute to over- or underestimation of the credit subsidy for the refinance loans in the program.

Recommendations for Executive Action

To ensure that field offices are aware of and implement current requirements and policies for the Section 232 Mortgage Insurance for Residential Care Facilities program, and reduce risk to the GI/SRI Fund, we recommend that the Secretary of Housing and Urban Development direct the FHA Commissioner to take the following actions:

- Revise the "Multifamily Asset Management and Project Servicing Handbook" in a timely manner to include monitoring requirements specific to Section 232 properties;

- Establish a process for systematically sharing loan underwriting and monitoring practices among field offices involved with the Section 232 program;

- Assure, as part of the department's strategic human capital management efforts, sufficient levels of staff with appropriate training and expertise for Section 232 loans;

- Incorporate a review of annual inspection reports for insured Section 232 facilities that are subject to federal or state inspections, even in the absence of a revised regulatory agreement; and

- Complete and implement the revised regulatory agreements in a timely manner.

To potentially improve HUD's estimates of the program's annual credit subsidy, we recommend that the Secretary of Housing and Urban Development explore the value of explicitly factoring additional information into its credit subsidy model, such as prepayment penalties and restrictions, debt service coverage and loan-to-value ratios of facilities as they enter the program, facility type, and the ratio of contract rates to market rates. We also recommend that the Secretary of Housing and Urban Development specifically explore other means of modeling the performance of Section 232 refinance loans.

Agency Comments and Our Evaluation

We provided a draft of this report to HUD for their review and comment. In written comments from HUD's Assistant Secretary for Housing-Federal Housing Commissioner, HUD generally concurred with our recommendations intended to ensure that field offices are aware of and implement current program requirements and policies. However, the agency disagreed with most parts of our recommendation related to HUD's credit subsidy model. The Assistant Secretary's letter appears in appendix V.

HUD stated that it has initiated a full review of the Section 232 program and that GAO's recommendations related to ensuring that field offices are aware of and implement current requirements are being incorporated into plans for revising the program. More specifically, HUD stated that it:

- will draft and implement changes to the program handbook;
- will initiate staff training and assure that staff is adequately trained in underwriting and servicing policies; and
- plans to prepare a report addressing state and federal inspections, among other things, to enhance FHA participation in and oversight of insured health care mortgages.

HUD also provided a timeline by which to complete and implement the revised regulatory agreements.

Concerning our recommendation that HUD explore the value of explicitly factoring in additional information into its credit subsidy model, HUD stated that it agreed to take into account differences among types of residential care facilities in its modeling, when it has sufficient historical data and if the data indicate that loan performance varies sufficiently by type of facility. However, HUD disagreed with considering other factors we suggested, as follows:

- *Initial loan-to-value and debt service coverage ratios*. HUD stated that (1) studies we cited in our draft report found these ratios to be statistically insignificant in predicting commercial mortgage defaults and (2) that data are unavailable for this analysis. We agree, as our draft report stated, that economic studies have shown mixed results regarding the significance of the impact of loan-to-value and debt service coverage ratios on commercial mortgage defaults, with some studies finding them to be significant predictors and others finding them to be insignificant predictors. We further stated that these mixed results may be the result of small sample sizes and model specification issues. Nevertheless, we continue to believe that HUD should explore the value of factoring initial loan-to-value ratio and debt service coverage ratio into its credit subsidy model, and we did not change our recommendation. Regarding the second point, HUD has the data for analyzing loan-to-value and debt service coverage ratios in individual loan files and could include these data in its credit subsidy modeling by creating an electronic record of this information either for its entire portfolio or for a sample of the portfolio. Consequently, we did not change the recommendation.

- *Factors potentially affecting prepayments*. HUD disagreed with our suggestion that its credit subsidy model does not fully capture the effects of prepayment penalties, stating that its use of historical data captures the effect of prepayment penalties on project owners' behavior. However, as we stated in the draft report, HUD's use of historic data would not fully capture trends related to changes in prepayments. HUD also stated that it has tested using the difference between mortgage interest rates and the 10-year Treasury bond rates in its modeling of prepayments. However, our recommendation was to consider a ratio of these two interest rates, not the difference. As we noted in our report, economic theory suggests that the use of a ratio is the best way to capture the effects on existing loans when market interest rates change. Consequently, we did not change the recommendation.

- *Use of Section 207 loans as proxy data for refinance loans.* HUD stated that it did not believe that the differences between Section 207 and

Section 232 loans that our report noted justify concerns that residential care refinance loans are being improperly modeled and noted a lack of available data. We agree that sufficient relevant data on Section 232 refinance loan performance do not yet exist, but we continue to question the use of Section 207 loan data as a proxy. While we did not change the recommendation, we added language to our report suggesting that, until enough Section 232 refinance loan data are available, one possible approach, among others, would be to use a simpler estimation method, such as using average claim and prepayment rates over time as is done in estimating credit subsidy rates for the Section 242 Hospital Mortgage Insurance program.

We are sending copies of this report to the Secretary of the Department of Housing and Urban Development (HUD). We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report or need additional information, please contact me at 202-512-8678 or woodd@gao.gov. Contact points for our offices of Congressional Relations or Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.

David G. Wood, Director
Financial Markets and Community Investment

List of Congressional Addressees

The Honorable Christopher Bond
Chairman
The Honorable Patty Murray
Ranking Member
Subcommittee on Transportation,
Treasury, the Judiciary, Housing and Urban
Development, and Related Agencies
Committee on Appropriations
United States Senate

The Honorable Jack Reed
Ranking Minority Member
Subcommittee on Housing and Transportation
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Joe Knollenberg
Chairman
The Honorable John W. Olver
Ranking Member
Subcommittee on Transportation, Treasury, and
Housing and Urban Development, The Judiciary,
District of Columbia, and Independent Agencies
Committee on Appropriations
House of Representatives

The Honorable Lincoln Chafee
United States Senate

The Honorable Patrick Kennedy
House of Representatives

The Honorable James Langevin
House of Representatives

Objectives, Scope, and Methodology

Our objectives were to examine (1) the Department of Housing and Urban Development's (HUD) overall management of the program, including loan underwriting and monitoring; (2) the extent to which HUD's oversight of insured health care facilities is coordinated with the states' oversight of the quality of care provided by facilities; and (3) the financial implications of the program to the General Insurance/Special Risk Insurance (GI/SRI) Fund, including risk posed by program and market trends; and (4) how HUD estimates the annual credit subsidy for the program, including the factors and assumptions used. In addition, we examined HUD's action in response to a HUD Inspector General report that concluded that HUD's Office of Housing did not have adequate controls to effectively manage the Section 232 program; this information is summarized in appendix III.

To examine HUD's overall management of the Section 232 program, we obtained and reviewed program manuals, guidance, and documentation, including the "MAP Guide," HUD's Section 232 "Mortgage Insurance for Residential Care Facilities Handbook," and HUD's "Multifamily Asset Management and Project Servicing Handbook," for loan processing procedures, underwriting policies and requirements, and oversight policies and requirements. We also interviewed HUD officials at HUD headquarters who are responsible for providing guidance and policies on loan underwriting and oversight and three private lenders that offered FHA-insured Section 232 loans. In addition, we conducted site visits to five HUD field offices (Atlanta, Georgia; Buffalo, New York; Chicago, Illinois; Los Angeles, California; and San Francisco, California) and conducted interviews with HUD officials, including the Hub or acting Hub director, appraisers, mortgage credit analysts, and project managers that are responsible for Section 232 loan applications, underwriting, and oversight, as well as other Federal Housing Administration (FHA) programs. We gathered relevant program documentation from each site visit. We also interviewed an official from one of HUD's Multifamily Property Disposition Centers during our site visit to Atlanta. To capture a variety of Section 232 loan activity, we selected five HUD field offices on the basis of (1) the volume of Section 232 loans the field office had processed during fiscal year 2004 up to September 2005; (2) the dollar amount of Section 232 loans processed in the field office during fiscal year 2004 up to September 2005; (3) the timeliness of processing Section 232 loans during the last 2 years; (4) historical claim-rate data for the field office—that is, the rate at which Section 232 loans processed by the field office have gone to claim; (5) HUD's suggestions for field office site visits; and (6) geographical dispersion.

To better understand how private lenders that do not participate in the Section 232 program manage risks, we interviewed five private lenders that offered non-FHA insured loans to residential health care facilities. We also interviewed representatives of three residential care facilities with FHA-insured Section 232 loans to better understand the borrowers perspective of the Section 232 program.

To examine the extent to which HUD coordinated with states' oversight of quality of care provided by facilities, we reviewed FHA requirements for conducting management reviews and reviewing annual inspection reports. We also interviewed officials in FHA's Office of Multifamily Development and Office of Asset Management and field office officials about policies for coordination between FHA and state residential care oversight and rate setting agencies, as well as policies for review of annual inspection reports. In addition, we interviewed private lenders of FHA-insured and non-FHA insured residential care facilities to better understand common industry practices for coordination between lenders and state residential care oversight and rate setting agencies.

To examine the financial risks that the program poses to the GI/SRI Fund, we interviewed and obtained documentation from HUD's Office of Evaluation and analyzed HUD data on program portfolio characteristics, including number of loans by cohort, current insurance in force, geographic and lender concentration of loans, and claims. We also analyzed HUD data used for their refinance credit subsidy regression model. Specifically:

- To obtain the number of active and terminated loans and claim rate history, we analyzed data from extracts of HUD's F47 database, a multifamily database. We obtained extracts from HUD in May 2005, September 2005, and February 2006. Unless otherwise indicated, all analyses from the F47 data in the report utilized the May 2005 extract with subsequent updates from the other extracts and was current as of the end of fiscal year 2005. To assess the reliability of the F47 database extract, we reviewed relevant documentation, interviewed agency officials who worked with the database, and conducted manual data testing, including comparison to published data. Because of the small number of loans endorsed in individual fiscal years, we conducted analyses of cohorts that were created by combining data from 5 to 6 fiscal years. For claim rate analyses, we analyzed 5- and 10-year claim rates for the data based on the date of loan termination.

- Our analyses found 13 loans for which facility type information was not able to be determined from the extract. FHA administrators were able to determine the facility type for all but one of these loans using the Development Application Processing (DAP) system. This one terminated loan was excluded from facility type endorsement and claim rate analysis and, therefore, had little impact on this report. We also determined final endorsement date information to be missing from 799 records. Our analyses only used initial endorsement date information for which data was available for every record; therefore, there was no impact on this report. We also determined there were nine loans for which the facility type information was incorrect based on the endorsement date.[1] FHA administrators checked in the DAP system and confirmed the correct facility type for these loans; therefore, there was no impact on the report. We determined the data to be sufficiently reliable for analysis of number of active and terminated loans, as well as claim rates.

- To determine the proportion of the Section 232 Mortgage Insurance program's commitment authority to the larger GI/SRI Fund's commitment authority, we reviewed HUD's fiscal year 2006 budget.

- To determine the proportion of the Section 232 Mortgage Insurance program's unpaid principal balance to the larger GI/SRI Fund unpaid principal balance, we obtained the GI/SRI Fund's unpaid principal balance as of December 31, 2005 from HUD's Office of Evaluation. We also analyzed data from HUD's Multifamily Data Web site, which is extracted from HUD's F47 database, to determine the unpaid principal balance of Nursing Home Mortgage Insurance program loans as of December 31, 2005.[2]

- To determine the geographic concentration of loan properties in the program, we analyzed data current as of the end of fiscal year 2005 from our extract of HUD's F47 database. Our analysis determined property state data was missing for 270 project numbers. FHA administrators informed us that loans endorsed more than 20 years ago, before

[1]These nine loans were coded as assisted living facility loans in F47. However, these loans were endorsed prior to HUD insuring assisted living facilities in 1994.

[2]Department of Housing and Urban Development, "Insured Multifamily Mortgages Database," Multifamily Data, http://www.hud.gov/offices/hsg/comp/rpts/mfh/mf_f47.cfm (downloaded Feb. 24, 2006).

electronic records were maintained, may have missing data that is unavailable. Our analyses of geographic concentration of loan properties utilized only one record with missing property state data; therefore, there was little impact on our findings. We determined the data to be sufficiently reliable for analysis of geographic loan concentration.

- To determine the geographic concentration of loan dollars in the program we analyzed data current as of December 31, 2005, from HUD's Multifamily Housing Data Web site.

- To determine prepayment history in the program, we analyzed data from our F47 extract, current as of the end of fiscal year 2005. We also analyzed 5-and 10-year prepayment rates for the data based on the date of loan termination.

- To determine the appropriateness of using Section 207 refinance loans as proxy data in the Section 232 refinance loan credit subsidy estimate regression model, we analyzed data from several extracts from HUD's Office of Evaluation. The extracts contained the loan data used by HUD to calculate cumulative claim rates for Section 232 and 207 refinance loans for loans endorsed from fiscal year 1992 through fiscal year 2005. The extracts did not include termination codes for all terminated loans. We determined termination code data for these loans from HUD data current as of December 31, 2005, from HUD's Multifamily Housing Data Web site. We also combined the extracts to include all loans in one larger extract. In addition, we performed manual data reliability assessments of these extracts and determined that three loans should not have been included in the extracts because they had section of the act codes that were not within the parameters of our analysis as defined by the notes included in HUD's extracts. These loans were not included in our analysis and, therefore, had no impact on our findings. We determined the data to be sufficiently reliable for analysis of the comparability of Section 207 refinance loans to Section 232 refinance loans.

We conducted a literature review and interviewed numerous officials of lenders, residential care associations, and HUD to obtain information on risks due to health care market trends. We also searched for Inspectors General and agency reports through HUD Web sites. Finally, we conducted a search on our internal Web site to identify previous work on the Section 232 program.

To determine how HUD estimates the annual credit subsidy rate for the program, we reviewed documentation of HUD's credit subsidy estimation procedures, reviewed the cash flow model for the program, and we interviewed program officials from HUD's Office of Evaluation and program auditors from the Office of Management and Budget (OMB). We also compared the assumptions used in HUD's cash flow model with relevant OMB guidance and reviewed economic literature on modeling defaults to identify factors that are important for estimation. Additionally, we analyzed data provided by HUD field offices on initial loan-to-value ratios and debt service coverage ratios (at the time of loan application). We obtained the credit subsidy rates from the Federal Credit Supplement of the United States Budget.

To review the actions HUD has taken in response to the HUD Inspector General's 2002 report on the Section 232 program, we interviewed officials in HUD's Office of Inspector General. In addition, we reviewed the HUD Inspector General's 2002 report, as well as HUD's Management Plan Status Reports for Implementation of Recommendation 1A of audit 2002-KC-0002. We also interviewed HUD headquarters officials, as well as field office officials during our site visits.

Our review did not include an evaluation of underwriting criteria or the need for the program. We conducted our work in Atlanta, Georgia; Buffalo, New York; Chicago, Illinois; Los Angeles, California; San Francisco, California, and Washington, D.C., between February 2005 and April 2006, in accordance with generally accepted government auditing standards.

Information on the Application Processing, Underwriting, and Oversight of Section 232 Loans

Application Processing and Underwriting for Section 232 Loans

The Department of Housing and Urban Development (HUD) currently processes a majority of the Section 232 loans using the Multifamily Accelerated Processing (MAP) program and processes some loans under Traditional Application Processing (TAP). Under MAP, the lender conducts the underwriting of the loan and submits a package directly to the Hub or program center for mortgage insurance. The Hub or program center reviews the lender's underwriting and makes a decision whether or not to provide mortgage insurance for the loan. New construction and substantial rehabilitation loans require a preapplication meeting where HUD reviews required documentation up front. Under TAP, HUD, not the lender, is primarily responsible for the underwriting of the loan and determines whether or not to accept the loan.

FHA has numerous underwriting requirements for loans made under the Section 232 program. Some examples include:

- Requiring documentation of a state-issued Certificate of Need (CON) for skilled nursing facilities and intermediate care facilities, and in states without a certificate of needs procedure, an alternative study of market needs and feasibility.
- Requiring an appraisal of the facility (prepared by the lender under the MAP program) and a market study with comparable properties.
- Reviewing current or prospective operators of the residential care facility and ensuring that they meet certain standards. For example, FHA has a requirement that operators of an assisted living facility have a proven track record of at least 3 years in developing, marketing, and operating either an assisted living facility or a board and care home.[1]
- For new construction facilities specifically, FHA requires a business plan along with an estimate of occupancy rates and prospective reimbursement rates with the percentage of population for patients whose costs are reimbursed through Medicare and Medicaid.
- For existing facilities applying for a refinance loan, FHA requires the submission of vacancy and turnover rates and current provider agreements for Medicare and Medicaid, 3 years of balance sheet and

[1]U.S. Department of Housing and Urban Development, Notice H 97-01, 4.

operating statements, as well as the latest inspection report on the project's operation.[2]

- Requiring limits on loan-to-value and debt service coverage ratios, ratios identified by field office officials we interviewed as two of the more important financial ratios in the underwriting process. For example, for Section 232 loans, the loan-to-value ratio cannot exceed 90 percent for new construction loans, and 85 percent loan-to-value for refinance loans.[3]

For loans processed under MAP, HUD field office officials are required to use MAP Guide checklists to ensure that lenders follow FHA's underwriting requirements. These checklists contained guidelines for reviewing lender submissions and overall parameters that an application must meet. For example, field office officials use an appraisal review checklist in the MAP Guide to ensure that the submitted market study complies with MAP requirements. For applications processed under TAP, field office officials stated that they use similar checklists to the ones included in the MAP Guide as the MAP Guide incorporates many of the Section 232 underwriting requirements.

For MAP loans, HUD headquarters has a Lender Qualifications and Monitoring Division (LQMD) that conducts reviews of loans. LQMD is responsible for evaluating lender qualifications and lender performance. It reviews and ultimately approves lenders requesting MAP lender approval for loan underwriting. The division reviews a sample of lenders when a loan has defaulted or there is a need for additional lender oversight. While LQMD reviews are not specific to the Section 232 program, they help to monitor lenders participating in the program and ultimately help to reduce the number of risky loans that enter the portfolio.

[2]According to the MAP Guide, the latest state residential care facility agency's report on the project's operation is required. The MAP Guide provides mortgage insurance program descriptions, mortgagor and lender eligibility requirements, application requirements, HUD underwriting standards for all technical disciplines, construction administration requirements, and closing instructions.

[3]When determining the maximum insurable mortgage, HUD also has requirements regarding the acquisition costs and net earnings. For nonprofit mortgagors, the loan-to-value cannot exceed 95 percent for new construction loans and 90 percent for refinance loans.

Oversight and Monitoring of Section 232 Loans

FHA requires field office staff to conduct a number of reviews for oversight of Section 232 loans. For example, staff address noncompliance items that are identified by HUD's Financial Assessment Sub-System (FASS) for each facility. Noncompliance items can include items such as unauthorized distribution of project funds or unauthorized loans from project funds. Using information from the annual financial statement, FASS's computer model statistically calculates financial ratios, or indicators, for each facility, and applies acceptable ranges of performance, weights, and thresholds for each indicator. FASS then generates a score for each facility based on these indicators, and this financial score represents a single aggregate financial measure of the facility. However, a HUD draft contractor study found that FASS did not adequately account for the unique nature of nursing homes in the Section 232 portfolio and, therefore, was a poor predictor of a nursing home going to claim. Field office officials we interviewed also review physical inspections conducted by HUD's Real Estate Assessment Center (REAC), which is responsible for conducting physical assessments of all HUD-insured properties. Officials also ensure that the professional liability requirement for facilities is met and conduct file reviews to identify any activities that warrant additional oversight.[4] Additionally, officials in each field office we visited stated that they are required to monitor projects in HUD's Real Estate Management System, the official source of data on HUD's multifamily housing portfolio that maintains data on properties and to conduct risk assessments on their properties at least once a year to identify those facilities that are designated as troubled or potentially troubled based on their physical inspection, financial condition, and other factors.

Field offices also varied in the utilization of HUD's Online Property Integrated Information Suite (OPIIS), a centralized resource for HUD multifamily data and property analysis. According to officials at HUD headquarters, field office officials can use OPIIS to conduct a variety of portfolio analysis and view risk assessments on their properties to better assist them in overseeing their portfolios. For example, OPIIS contains an Integrated Risk Assessment score that combines financial, physical, loan payment status history, and other data into a score that can be used to

[4] In April 2001, HUD issued Notice H01-03, titled "Review of Health Care Facility Portfolios and Changes to the Section 232 Programs." Section X of the notice established the requirement that HUD-insured health care facilities maintain professional liability insurance. Housing Notice 04-15 lists the requirements for professional liability insurance for owners and operators of health care facilities.

identify at-risk properties and prioritize workloads. However, four of the five field offices that we visited did not frequently use OPIIS. Some of these offices used the system to develop risk rankings for their properties or in trying to obtain data about a property, but none of them regularly used the system for the monitoring of Section 232 loans. The one field office that utilized OPIIS more frequently did so because the system partly incorporates a loan risk and rankings system that the field office had previously developed for its own use. Officials in this field office stated that an issue with OPIIS is that it is not designed to capture important, specific financial information that is unique to some Section 232 loans, such as expenses on food or medication.

HUD Officials Addressed Some Issues Raised by the Agency's Inspector General in 2002, but Several Key Items Remain Unresolved

In a 2002 report, the Department of Housing and Urban Development's (HUD) Inspector General found that HUD's Office of Housing did not have adequate controls to effectively manage the Section 232 program.[1] Because of these weaknesses, the Inspector General found that HUD lacked assurance of the effective operation of Section 232 properties. The Inspector General noted that the Office of Housing had already taken steps to develop an action plan to address the weaknesses identified by a task force, but that time frames had not yet been established. The Inspector General recommended that the Office of Housing establish specific time frames for implementing the corrective actions for the 10 weaknesses identified by the task force and that it monitor the actions to ensure timely and effective completion.

HUD officials developed a plan to correct the 10 control weaknesses identified by the Office of Housing, which included the current status of each action and specific target dates to complete the corrective actions. According to the Inspector General, HUD has taken action to address 2 of the 10 control weakness findings identified by the Office of Housing Task force and for which the Inspector General recommended that timelines for corrective actions be established.

The eight unresolved control weaknesses identified by the Office of Housing task force are all contingent upon approval of the proposed revisions to the regulatory agreements. However, the proposed revisions have been awaiting approval since August 2, 2004. According to HUD officials, the delay is a result of numerous administrative issues, which include changes in FHA management and extended public comment periods.

The addressed control weaknesses and respective corrective actions involved loan underwriting. The Inspector General agreed with the Office of Housing task force, which found that HUD's underwriting process for Section 232 properties needed to be strengthened and that HUD needed to complete market studies and background checks of applicants as part of the process. The Inspector General also agreed with the Office of Housing task force's finding of potential problems associated with the nonrecourse nature of HUD Section 232 loans. In particular, it found that HUD needed to

[1]Department of Housing and Urban Development, Office of Inspector General, *Nationwide Survey of HUD's Office of Housing Section 232 Nursing Home Program*, 2002-KC-0002 (Kansas City, Missouri, 2002).

strengthen the regulatory agreements and underwriting process for Section 232 loans if these mortgages were to remain nonrecourse and to avoid potential increase in the portfolio claim rate. HUD addressed these findings by adding requirements for operators, reviews of operators' financial statements, and professional liability insurance. Furthermore, applications for projects that are considered marginal are rejected.

The eight remaining control weaknesses for which HUD has not fully completed its corrective actions are as follows:

HUD lacks a handbook detailing monitoring requirements for nursing homes and assisted living facilities. The Inspector General found that HUD did not have a handbook specific to the Section 232 program monitoring requirements ensuring that all facilities follow the applicable regulatory agreements and state and federal requirements. In our site visits to five field offices, we found inconsistencies in the extent to which oversight procedures were followed, such as requiring operators to submit financial statements. HUD plans to include Section 232 project monitoring requirements in the "Multifamily Asset Management and Project Servicing Handbook" once the proposed revisions to the applicable regulatory agreements have been approved. In addition, HUD headquarters officials told us that they plan to issue updated guidance on loan oversight for Section 232 properties while awaiting approval of the proposed revisions to the regulatory agreements.

HUD's regulatory agreement does not include specific requirements for Section 232 properties. The Inspector General found that the regulatory agreement for owners lacked requirements for Section 232 properties, such as compliance with Medicare and Medicaid guidelines. The Inspector General also found inconsistencies between the requirements for facilities operated by the owners and those operated by a separate entity. The Inspector General recognized that these omissions created an inability for HUD to control the activities of operators and ultimately created risk to the General Insurance/Special Risk Insurance Fund. HUD's proposed revisions to the regulatory agreements have provisions that address these concerns; however, they are still awaiting approval.

The Financial Assessment Subsystem (FASS) does not allow the owner and operator to submit annual financial statements electronically, denying HUD the ability to use the financial check and compliance feature in the system. The Inspector General found that the Real Estate Assessment Center's (REAC) FASS did not include all Section 232 properties. Furthermore, operators were not required to submit annual financial statements electronically through the system. HUD headquarters officials agreed that, while operators are unable to submit annual financial statements electronically, FASS has allowed electronic submissions from owners since the system's inception. However, the Inspector General found that because operator financial statements are not required to be submitted electronically, HUD is unable to utilize the financial and compliance checks performed within the system to identify and follow up on deficiencies. HUD plans to modify FASS to allow electronic submission of operator financial statements; however, implementation has been delayed by funding problems and approval of the proposed revision to the operator regulatory agreement.

The Office of Housing needs to improve monitoring and legal tools to provide early indication of possible default. The Office of Housing task force identified a need for improved monitoring and legal tools to provide early indication of potential default. To better understand issues related to monitoring loans, HUD's Office of Evaluation completed several studies on Section 232 program performance.[2] As of April 2006, all of these studies remain in draft form. Also, to aid in monitoring, HUD has proposed revisions to the applicable regulatory agreements to require that owners and operators submit annual inspection reports and inform HUD of state or federal violations. These reports can be an early indicator of quality of care concerns and possible claim. However, the proposed revisions to the regulatory agreements have not been made final.

The Office of Housing staff needs additional training on servicing nursing homes and assisted living facilities. The Inspector General identified that project managers did not have sufficient training on reviewing Section 232 properties and dealing with the issues unique to Section 232 properties. HUD's management plan states that, as of September 2004, REAC has conducted financial statement analysis for HUD hubs for the last 2 fiscal years. HUD has also proposed training specific to Section 232 program financial analysis upon approval of revisions to the applicable regulatory agreements and subject to the

[2]These studies include: FHA, *Review of HUD Disposition and Asset Management Practices* (Draft), May 12, 2004; *Proposed Benchmark Report Containing Per Unit Multifamily Expense and Revenue Data for 75 MSAs*, (Draft), Aug. 2, 2004; *Effect of Rising Insurance Costs on FHA-Insured Multifamily Mortgages* (Draft), Mar. 16, 2004; and *Analysis of FHA Endorsed Mortgages Presented for Claim in FY 2003* (Draft), May 14, 2004.

availability of funds. However, HUD headquarters officials stated that there were very limited funds available for training.

Certain conditions lead to loss of Certificate of Need (CON) or license. The HUD Inspector General identified that, in some states, the CON and operating licenses may not transfer with the property. Consequently, an operator may hold these operational documents and take them with them upon termination of the lease. Without these documents, a facility is not viable as a residential care facility and its value is significantly diminished. This presents a large risk to HUD should the loan go to claim or should HUD have to acquire the property. HUD's proposed revisions to the applicable regulatory agreements address this concern by categorizing these operational documents as part of the mortgaged properties.

Receivables need to be included in the relevant legal documents to strengthen HUD's control over assets of the property in case of regulatory agreement violations.[3] The Inspector General established that the Section 232 security agreement language was too broad to ensure that all property assets are covered by the mortgage. To address this concern, HUD proposed revisions to the applicable regulatory agreements to include receivables in the personalty pledged as security for the mortgage. Additionally, HUD proposed added language in the owner regulatory agreement requiring the owner to execute a security agreement and financial statement upon all items of equipment and receivables.

Field offices do not have consistent procedures for using different addendums for mortgages, regulatory agreements, and security agreements. The Office of Housing's task force found inconsistencies in the field offices' use of legal agreements between HUD and owners and operators, such as differing addendums to mortgages, regulatory agreements, and security agreements. We also found similar discrepancies during our five site visits. For example, only one office used addendums to HUD's legal agreements to prevent operators from keeping these operational documents once the lease terminates. HUD has proposed revisions to the regulatory agreements, and once they are approved and implemented all offices will use the same legal documentation. In the

[3]Receivables are the value of services billed to third-party payors that have yet to be received. An example of receivables is the value of Medicare services billed to the federal government that have not yet been reimbursed.

interim, HUD headquarters officials told us they plan to provide field offices with updated guidance on Section 232 loan oversight.

HUD's Use of Proxy Data for Refinance Loans

As discussed earlier in this report, we question the Department of Housing and Urban Development's (HUD) use of Section 207 loans as a proxy for Section 232 loans in the claim regression that is part of HUD's credit subsidy estimates. This appendix provides greater detail on our analysis.

HUD's Comparison Did Not Allow for Differences in the Age of Loans

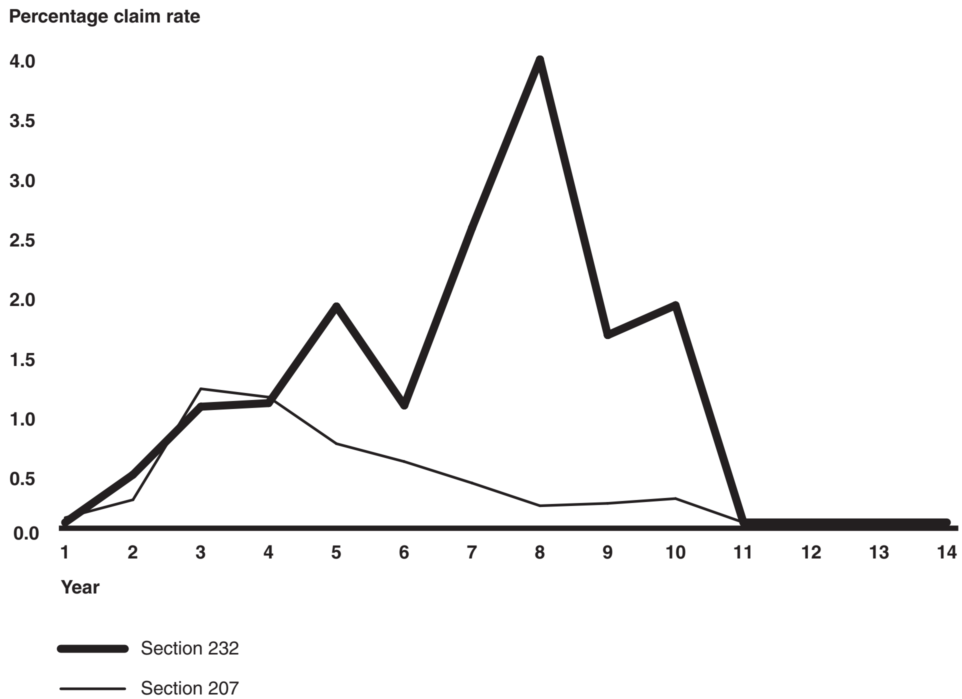
Cumulative claim rates are generally compared for a set period of time and for loans from the same years of origination. However, HUD calculated the cumulative claim rates without making these adjustments, which confounds claim differences between programs with differences due solely to timing. HUD calculated the cumulative claim rates for each program by taking the total number of loans that went to claim during a 14- year time period and dividing this by the total number of loans in that same time period. In this case, HUD was comparing a program that has been expanding over time, the Section 232 program, with a program that has had less loan volume in recent years, the Section 207 program. From 1992 to 1998, HUD insured 1,434 Section 207 loans. From 1999 to 2005, HUD insured 870 Section 207 loans. As a result, HUD has been comparing the claim rate of loans that have had very little time in which to default (Section 232 loans had an average age of 4 years) with the claim rate of loans that have had substantial time in which to default (Section 207 loans had an average age of 7.5 years). A comparison between two programs' claim rates should allow for differences in the age of the loans. HUD officials also told us that they have not analyzed the comparability of these two loan types in terms of their prepayment rates.

Substantial Differences Exist between Section 207 and Section 232 Loans

To examine the comparability of the Section 207 and Section 232 loans, we compared the conditional claim and prepayment rates of the two types of loans. An analysis of conditional claim and prepayment rates compares claim and prepayment probabilities for loans of the same age, so that comparisons based on loans of widely varying ages are avoided.

We found that the Section 207 loans generally had lower and, in some cases, significantly lower conditional claim rates than the Section 232 loans. The differences were greater in the later years when loans more often go to claim. (see fig. 7). For example, the conditional claim rate for Section 207 loans in fiscal year 8 was .14 percent as compared with a conditional claim rate of 3.88 percent for Section 232 loans in fiscal year 8.

Figure 7: Conditional Claim Rates Are Different for Section 232 and Section 207 Refinance Loans

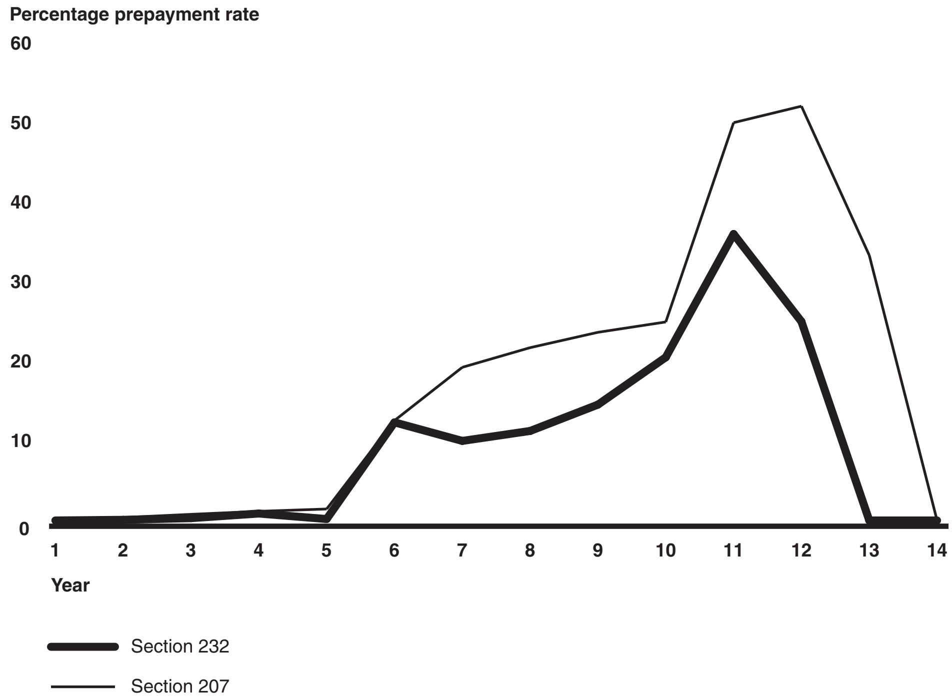


Source: GAO analysis of data from HUD's Office of Evaluation and from F47 (a HUD multifamily housing database) as of the end of fiscal year 2005.

Note: Through year 8, there are at least 200 loans in each category of loan for each conditional claim rate year. Beyond year 8, the loan numbers are small (particularly for Section 232 loans), and conclusions are less reliable.

We found that Section 207 loans had generally higher, and sometimes significantly higher, conditional prepayment rates compared to Section 232 loans. The differences were greater in the later years when loans more often are prepaid. (see fig. 8). For example, the conditional prepayment rate for Section 207 loans in fiscal year 8 was 21.72 percent as compared to a conditional prepayment 11.25 percent for Section 232 loans in fiscal year 8 (making the conditional prepayment rate for the Section 207 loans 93 percent higher than the conditional prepayment rate for Section 232 loans).

Figure 8: Conditional Prepayment Rates are Different for Section 232 and Section 207 Refinance Loans



Source: GAO analysis of data from HUD's Office of Evaluation and from F47 (a HUD multifamily housing database) as of the end of fiscal year 2005.

Note: Through year 8, there are at least 200 loans in each category of loan for each conditional prepayment rate year. Beyond year 8, the loan numbers are small (particularly for Section 232 loans), and conclusions are less reliable.

Additionally, we examined and compared cumulative 5-year claim and prepayment rates. Section 207 loans had a 5-year cumulative claim rate of 3 percent, while for the Section 232 loans it was approximately 6.7 percent. The 5-year cumulative prepayment rate for Section 207 loans was about 27 percent, while for Section 232 loans it was about 11 percent.

Comments from the Department of Housing and Urban Development

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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

MAY 12 2006

Mr. David Wood
Director, Financial Markets and
Community Investment
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Wood:

Thank you for the opportunity to respond to the draft report entitled *Residential Care Facilities Mortgage Insurance Program: Opportunities to Improve Program and Risk Management (GAO-06-515)*. The Department plans to implement the GAO recommendations as follows:

The Department has already separated the revision of the healthcare regulatory agreements and other closing documents from the rental housing revisions, so that specific focus can be placed on assuring the unique nature of health care operating structures and oversight will be adequately addressed in those revisions.

June 30, 2006 – Conclude industry and stakeholder fact gathering that began in March 2006 to better define the role of the FHA 232 program in providing mortgage insurance for the critical healthcare market segment.

September 30, 2006 - Prepare report addressing key ownership and operator structure and agreements including conventional mortgage practices for project oversight, available third party sources for project operations review, state and federal inspections, receivables financing, insurance practices and policies, and risk management approaches to enhance FHA participation in and oversight of insured healthcare mortgages.

March 31, 2007 – Complete plan to implement findings and draft appropriate policy and handbook changes. Recommend organizational changes to assure adequate skills and staffing are dedicated to the healthcare programs. Complete the revisions of the regulatory agreements and closing documents. Prepare regulatory changes for clearance and publication in the Federal Register. Initiate staff training based upon proposed changes and implement program changes that do not require regulatory clearance.

February 28, 2008 – Fully implement the revised healthcare program assuring that staff is adequately trained in the underwriting and servicing policies and adherence to those policies is consistent across all responsible areas.

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The Department believes that these actions will fully accomplish the recommendations made by Report GAO-06-515 related to program redesign, enhanced staff and organizational structure, and asset and risk management. However, for reasons already explained to the GAO, the Department does not agree with the GAO's recommendations for changes to the annual credit subsidy estimations. This disagreement is based upon the following:

The GAO recommends that a property's loan-to-value and debt service coverage ratios at origination should be included in the econometric models used to estimate conditional claim rates for Section 232 loans. The data is unavailable for analysis and is unlikely to be statistically significant if they were available. GAO acknowledges that recent statistical studies have found no statistical relationship between ratios at origination and subsequent performance.

The GAO contends that FHA's models suffer from a failure to capture prepayment penalties. Because FHA uses all of its historical experience to model conditional prepayment rates, it is capturing the effect of prepayment penalties on project owners' behavior. The GAO report goes on to state that FHA does not capture the effect of changes in market interest rates in its prepayment models. In fact, FHA does include both the mortgage interest rate and the 10-year Treasury bond rate in its models and has tested using the difference between the two as an explanatory variable. FHA uses the model specification with the greatest explanatory power. Each year FHA tests alternative specifications and will continue to test whether inclusion of the rate difference will improve its models.

The report questioned the use of multifamily refinance loans as proxy data for residential care refinance loans, but did not recommend another source of historical data that could be used to generate performance estimates. Given the sparsity of available data, FHA does not believe that the differences noted in Appendix IV are great enough to justify concern that residential care facility loans are being improperly modeled.

The GAO recommends taking into account the differences among types of residential care facilities in its modeling. FHA agrees to do so when sufficient historical data are available and if the data indicate that loan performance varies sufficiently by type of facility to warrant the creation of new risk categories.

The Department acknowledges the unique nature of these healthcare loans and the resulting need for specialized underwriting and oversight. To that end, the Department has initiated a full review of the program and has found the added insight and recommendations provided by the GAO report to be very useful. These recommendations, along with those previously made by the Inspector General are being incorporated into the findings that will be the basis for program revisions.

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If you have any questions concerning this response, please contact Charles H. (Hank) Williams, Deputy Assistant Secretary for Multifamily Housing Programs at (202) 708-2495.

Sincerely

Brian D. Montgomery
Assistant Secretary for Housing-
Federal Housing Commissioner

GAO Contact and Staff Acknowledgments

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David G. Wood (202) 512-8678

Staff Acknowledgments

In addition to the individual named above, Paul Schmidt, Assistant Director; Austin Kelly; Tarek Mahmassani; John McGrail; Andy Pauline; Carl Ramirez; Richard Vagnoni; Wendy Wierzbicki; and Amber Yancey-Carroll made key contributions to this report.

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