U.S. Department of Housing and Urban Development

Minneapolis Field Office
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http://www.hud.gov/local/min/minhome.html

MEMORANDUM FOR: Minnesota MF Hub Lenders

SUBJECT: Underwriting Issues

Date: December 19, 2002

Recently, three related and recurring problems emerged that the MF Hub would like corrected by affected lenders preparing and submitting applications:

1. Base rents without any meals or services inappropriately analyzed in "independent" seniors' rental housing;
2. Over-sized wings of under-sized and over-priced memory care (MC) units in assisted living facilities (ALF's); and
3. Unrealistically low Operating Expense Ratios (OERs) used to underwrite ALF's.

Accordingly, we request that applicable projects be closely scrutinized and underwritten with the following corresponding requirements in mind.

Requirement 1- Section 221 (d)(4) age-restricted unit types' reflected on Form HUD 92273's *must* be analyzed using base rents only, with no meals or services included, and must be *verified and compared* in that sub-market to the newest seasoned general occupancy units available.

FHA has not insured mortgages on Retirement Service Centers (ReSC's) for several years. Initially marketed as luxury accommodations for the elderly, many ReSC's failed and were converted into entry-level ALF's. The Section 221 (d)(4) program has continued to allow age-restricted housing for the elderly, so long as ReSC-like project amenities/ costs/ income are excluded from the underwriting, and only strict "shelter-related" features are included as the focus of the analyses. Many projects that are labeled "independent" are actually marketed and managed as exclusive seniors' rental housing for *dependent,* frail elderly individuals or couples. This apparent paradox has the potential to render FHA's exclusion of ReSC's from its programs ineffectual, since many services are offered such residents on site by related and third-party providers from offsite.

So long as lenders honor the underlying premise of this program allowance- that only the housing/shelter elements be considered in the analyses- then this Hub may process such applications. MAP lenders, please see Paragraphs 3.5 C, 3.8 D and 11.2 J3 of the MAP Guide. But frequently, lenders prepare and submit, or allow their appraisers to complete and they then package, Form HUD 92273's that contain comparable unit rents containing *more than* just shelter-related base rent. Heretofore, the Hub has re-underwritten these projects at some added time and expense, reflecting housing-only rents (without meals or services). Henceforth, we will reject such underwriting, and hold the lender directly accountable to the borrower for any lengthy re-analysis, delay, and modifications occasioned by non-compliance with this requirement.

In analyzing such unit rents, we further require that at least one general occupancy/non-age-restricted rent comparable, located as near the subject as possible, be utilized for each different unit type. This requirement is based upon the belief that general occupancy units that some elderly prefer often reflect what shelter-only rents prevail in a given location. Such a comparable should be of recent vintage (less than 10 years old, ideally), but also partially seasoned (at least one lease renewal or turnover/unit). Underwriting submitted with comparable rentals that include non-housing services revenue, or that does not include a general occupancy comparable located nearby as a "cross-check" on shelter-only rent levels, will be rejected.

Requirement 2- Memory Care (MC- aka Altzheimers) units must not exceed 10% of total units in an assisted living facility (ALF); if they do, they must be designed and underwritten the same as average-sized and -priced assisted living units available in that same project.

Several recently processed ALF's included sizeable wards/wings of MC units in the project. MC units are typically much *smaller* than general population ALF units in square footage and cost. Due to the specialized care associated, however, MC units typically garner *higher* monthly charges. The temptation to underwrite more than 10% of total ALF units as MC may prove irresistible because of the income/cost dynamics involved. However, if an excessive proportion of MC units are built in one project, or an excessive number of MC units in the overlapping subject market, these small, Spartan units cannot rent for even as much as larger vacant entry-care ALF units. Consequently, improved market research and greater care must be exercised in the proper sizing (both MC wing and individual unit size) and pricing of these specialty units.

Henceforth, this Hub will underwrite no more than 10% of an ALF's total units at MC charges. In addition, no greater than 10% of an ALF project's units may be specially designed in relatively smaller square footage sizes for the purposes of MC. Any Section 232 application submitted with higher percentages of relatively small MC units, or higher MC-related charges, will either be rejected or very closely scrutinized for supporting market study data conclusively justifying the proposed exception from the 10% limitations.

Requirement 3- Operating Expense Ratios (OER's) for freestanding ALF's, depending upon the intensity of services and payroll involved, typically fall in the 60%-70% range, and should be underwritten accordingly.

Several ALF's have been submitted reflecting OER's more appropriate for apartment projects in the 40%-55% range. Because of the higher levels of services offered at all ALF's, and primarily, payroll and materials costs related to these services, the national average for such facilities is approximately 65%. FHA 232 processing must reflect what is typical in operations and the industry norm in operating efficiencies. It is unrealistic to expect an ALF to operate with the same payroll and materials as an ordinary apartment project.

Freestanding ALF's must be underwritten with achievable OER's, sustainable on a long-term stabilized basis (paraphrasing what it says in several Handbooks on the topic). If the ALF is to be a new construction wing of a Skilled Nursing Facility (SNF), to be combined with its higher intensity of operations and costly health-care related services, then using at least 60% for the ALF segment and 80%-90+% for the SNF portion would reflect the norm(s). As in existing apartment program refinance and purchase programs, pro forma underwritten expenses must be supported by the trailing three years' annual financial statements.

In order to avoid processing delays, questions relating to this memorandum's application to specific projects should be directed to either Tim Gruenes (612-370-3051 x 2252) or Del Relopez (x2274).