**HUD’s Lean 232 Program**

**Office of Residential Care Facilities (ORCF)**

**Update as of February 28, 2018**

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**Keys Amendment Letters Posted Online**

In response to industry requests, and with permission from the Social Security Administration (SSA), ORCF is now posting all **new** (2018 & forward) annual Keys Amendment certifications on the ORCF website ([here](https://www.hud.gov/federal_housing_administration/healthcare_facilities/residential_care/keysamendment)).  Each “X” on the chart not only indicates that a state has submitted their certification letter for calendar year 2018, but it is also a hyperlink to the certification itself.  As a reminder (and as discussed in our [October 25, 2017 Email Blast](https://www.hud.gov/sites/dfiles/Housing/documents/Oct25EmailBlast.docx)), the state letter is not the only requirement for Board and Care eligibility; each project must be specifically regulated by the state, pursuant to Section 1616e of the Social Security Act, and meet all other ORCF requirements.

***Keywords:*** *Board and Care; Keys Amendment; Section 1616e*

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**Clarification of “Management Agent” Role**

ORCF has recently received inquiries regarding the role that will lead to a party’s designation as a facility’s “management agent.”  Per Handbook 4232.1, Section II, Chapter 8.3, a Management Agent is an entity that “directs the day-to-day functions of a healthcare project as a contracted agent for either the Operator or the Borrower.” The most fundamental *function* of a residential care facility is, of course, resident care.  Thus, while a Management Agent’s role will include a wide range of activities, those activities necessarily include resident care.  This specifically includes the selection and supervision of the administrator and the staff providing care and services to the residents.  Management agents thus include entities who have overall responsibility for resident care and for the operations that support that care, but who do not meet the definition of operator in Chapter 8.2 and are therefore not required to sign the Operator Regulatory Agreement.

The Management Agent role is distinguished from the role of the various parties with whom an operator may contract to optimally operate the facility (e.g., administrative services provider, back-office services provider, therapy provider, etc.)  Those parties would not (as a Management Agent does) go through a certification/approval process at the ORCF or lender level.  Any costs incurred for such services, however, must not exceed amounts normally paid for such services in the geographic area (pursuant to 24 CFR 232.1007 and to the borrower’s and operator’s regulatory agreements).  HUD may require that fees paid to a service provider be disclosed and substantiated as reasonable and necessary.

***Keywords:*** *Management Agent*

**Exclusion of the Cost Approach**

ORCF is noticing a trend to inappropriately exclude the Cost Approach in appraisals. The Lender may not request that the appraiser omit the approach. When the costs to construct and stabilize a potential new facility, including land, are well below the estimated market value for the subject property, there is a possibility that a competitor may be added to the market. Lenders are reminded that Handbook 4232.1, Section II, Chapter 5.3.R.2:

ORCF will expect to see a fully developed cost approach in cases where there is little depreciation or in cases where the undepreciated replacement cost new would be expected to be lower than the conclusions of the Sales Comparison or Income Capitalization Approaches. For that reason, base costs of new facilities will need to be carefully discussed in the narrative justification for excluding the approach.

Since “base costs” need to be carefully discussed in the narrative, most of the Cost Approach will already need to be completed and will prove insightful to the discussion.

***Keywords:*** *Cost Approach, Undepreciated Replacement Cost, Competition*

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**Flood Insurance Reminders**

Lenders are reminded that Handbook 4232.1, Section II, Production, 14.7.H addresses flood insurance requirements.  It is the lender’s responsibility to review the Standard Flood Hazard Determination Form as well as current and preliminary FEMA Maps prior to submission of an application.  Chapter 14.7.H requires that every mortgage insurance application must include a Standard Flood Hazard Determination Form (FEMA Form 086-0-32 or most recent version), prepared by a qualified third-party flood zone determination firm.  In addition, because the status of a flood zone may change over time, the Lender must obtain from its flood zone determination firm "life-of loan" monitoring and coverage.

For projects that require flood insurance, you are reminded that the following requirements apply:

1. HUD considers flood insurance to be a market expense that other lenders would also require, therefore, flood insurance costs should be included in the appraisal’s net operating income estimate as an expense.  This expense should also be included in the lender’s underwritten net operating income used to calculate debt service coverage.
2. The lender narrative and draft firm commitment should include a special condition requiring flood insurance as well as the following required flood insurance coverage amounts:
   1. The amount of the replacement cost of improvements located in the Special Flood Hazard Area (SFHA).  This number should be found in the PCNA for refinance projects and in the third-party cost report for construction projects.
   2. The amount of Business Income coverage as described in Handbook 4232.1, Section II, 14.7.H
   3. The maximum deductible amount, which cannot exceed 5% of the replacement cost of the mortgaged property.

***Keywords:*** *Flood Insurance*

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**Initial Operating Deficit Worksheet Preparation For Section 241 Applications**

As a reminder, Handbook 4232.1, Section II, Appendix 2.1, Calculating the Initial Operating Deficit Escrow, provides instructions on how to complete the Initial Operating Deficit (IOD) workbook.  Section 241 applications often do require an IOD when beds/units are being added, or payor mixes are changing.  As a reminder:

* Existing operations should be considered in the ‘number of preleases’ column;
* Changes to expense floor percentages must be justified;
* The Details and Draw Requests tab of the workbook automatically defaults to income commencing in month 3.  Manipulation of the monthly forecast columns is permitted, where appropriate, to reflect income being achieved in months 1 and 2;
* The combined debt service of both loans (existing and proposed) must be reflected in the principal/interest and MIP line items of the Details and Draw Requests tab;
* The actual proposed IOD amount must be included on the Details and Draw Requests tab; and
* In the situation where an IOD is not proposed, the IOD workbook is still required to be completed, to prove that the existing operations cover operations and debt service of both loans.

***Keywords:*** *Section 241, IOD*

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**Reconciling NOI History with Certified Financials**

An important part of the ORCF appraisal review is checking to see if the financial history summarized in the appraisal is reported accurately. This is done by comparing the historical net operating income (NOI) to the detailed income and expense statements, which are certified by the owner to be correct (exhibits 3-x-B or 5-x-B or 9-x-B). For the two to “balance”, expense “add-backs” are sometimes needed. Examples of add-backs are interest income, interest expense, depreciation, amortization, property rent, lawsuits, fund raising activities, and major capital improvements. Currently the review appraiser’s reconciliation table is found in the Decision Circuit, but we hope to have a place for it in a future version of the 223(f) Lender Narrative Template. The lender will be asked for clarifications when the review appraiser is unable to reconcile the reported history with the certified financials. It is inappropriate to “normalize” any historical expense to market levels or include adjustments for corporate structure. Such “normalizations” will be reflected in the appraisal’s forecasts. The lender can speed the balancing process by describing the add-backs using the specific name or accounting code used in the certified financials.

***Keywords:*** *Lender Narrative, Certified Income & Expense, Financial History, Reconciliation, Balancing, Appraisal*

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**Document Links Included In This Blast**

1. [ORCF State Compliance with Keys Amendment Website](https://www.hud.gov/federal_housing_administration/healthcare_facilities/residential_care/keysamendment)

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Past Lean 232 Updates are [available online](http://portal.hud.gov/hudportal/HUD?src=/federal_housing_administration/healthcare_facilities/residential_care/mail_blast_index).

Have questions about the Lean 232 Program? Please contact [LeanThinking@hud.gov](mailto:LeanThinking@hud.gov).

For more information on the Lean 232 Program, check out: <http://www.hud.gov/healthcare>.

Have your loan servicing colleagues joined our email list? The Email Blasts contain information relevant to them as well. You might suggest they [Join here](http://portal.hud.gov/hudportal/HUD?src=/subscribe/signup&listname=Lean%20232%20Updates&list=LEAN-232-UPDATES-L).

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