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Section II Production

Chapter 3 Loan Sizing

3.1 Introduction

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10 This chapter contains the loan sizing requirements for the Section 232 Mortgage Insurance for
11 Residential Care Facilities program. Each loan program has different criteria for calculating the
12 maximum insurable loan amount. The sections below describe which criteria to use for each
13 program, and how to calculate each criterion. The maximum insurable loan amount is the lowest
14 of all of the criteria rounded down to the nearest 100 dollars. The Maximum Insurable Loan
15 Calculation (Form HUD-92264A-ORCF) (MILC) is a required Firm Application exhibit and is
16 used to calculate the Maximum Insurable Loan.
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3.2 Underwriting Benchmarks for Section 232 New Construction, 232 Substantial Rehabilitation, 232 Blended Rate and 232/223(f) Loans

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20 Maximum Loan-to-Value Ratios (LTV) and minimum Debt Service Coverage Ratios (DSCR)
21 are set by statutes and regulations. To mitigate risk, the following underwriting benchmarks
22 have been established. Any submittals above the LTV or below the DSCR benchmarks require
23 substantial justification and mitigation. Please note that the DSCR benchmark is calculated
24 using the Mortgage Insurance Premium (MIP). To qualify for the higher Non-profit
25 benchmarks, the Owner-Operator must demonstrate a successful operating track record,
26 significant project operating and management experience, and a solid financial track record. The
27 minimum debt service coverage ratio is 1.45 for all project types with the exception of the
28 223(a)(7) and Section 232(i) programs, which require a debt service coverage ratio of at least
29 1.11. Regardless of which underwriting benchmark is used, a Non-profit Borrower must
30 establish a Residual Receipts account.
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Type of Unit	New/Existing Units	Borrower Type	Max. Loan to Value*
SNF/ILU	Both	For Profit	80%
SNF/ILU	Both	Non-Profit	85%
ALF	New	For Profit	75%
ALF	New	Non-Profit	80%
ALF	Existing	For Profit	80%
ALF	Existing	Non-Profit	85%

SNF = Skilled Nursing Facility; ILU = Independent Living Unit; ALF = Assisted Living Facility

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3.3 HUD Eligible Costs

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41 The following costs are considered eligible mortgageable costs for all programs except for
42 Operating Loss Loans (see Section 3.10) and the 232(i) Fire Safety Equipment Loan Program
43 (see Section 3.11). The Lender must provide evidence of these expenses and must justify how
44 they are reasonable relative to current market conditions.

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A. Eligible Mortgageable Costs

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- 47 1. **Existing Indebtedness.** Section 3.13 describes eligible existing indebtedness
48 requirements. (Eligible debt on Section 223(a)(7) transactions is addressed in
49 Production, Section 2.10Q).
- 50 2. **Interest on Existing Debt.** Interest accrued on existing debt may be included in the
51 determination of eligible debt.
- 52 3. **Prepayment Penalty.** The Lender must include the prepayment penalty that the
53 Borrower is likely to incur at the time of closing, not at the time of the Lender's
54 underwriting. This may include the yield maintenance fee.
- 55 4. **Interest Rate Premium (Section 223(a)(7) projects only).** The Lender may apply
56 proceeds from an interest rate premium on behalf of the Borrower to defray
57 prepayment penalties associated with the existing mortgage note. The amount needed
58 to pay off the existing indebtedness for purposes of MILC Criterion H must not
59 include any portion of the prepayment penalty that is being paid from an interest rate
60 premium. Criterion H of the MILC will automatically deduct the amount of the
61 interest rate premium disclosed on the S&U tab of the MILC. No portion of the
62 interest rate premium will go to the Borrower or any of its affiliates. Any unused
63 portion of the interest rate premium originally intended to defray prepayment
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penalties must be deposited into the Reserve for Replacement (R4R) account for future project needs.

5. **Initial Deposit to the R4R.** This amount is determined based on a R4R analysis completed by the Lender and reviewed by ORCF. These funds are deposited into the R4R account at closing.
6. **Existing R4R to Transfer.** On Section 232/223(a)(7) and 232/223(f)/(223(a)(7) projects, the existing R4R balance must be transferred to the new loan at closing.
7. **Estimate of Repair Cost (critical, non-critical and Borrower proposed).** The Lender's estimated repair costs to be incurred by the Borrower. Associated architect's fees, mechanical engineering fees, municipal inspection fees, and other similar fees may also be eligible. The Lender must provide evidence of these fees at the time of firm application and justify their eligibility. The contingency portion of the repair escrow agreement is not eligible.
8. **Appraisal (including updates).** Costs associated with completion of the Appraisal as part of the Firm Application submission. The Appraisal must be completed in compliance with the ORCF Appraisal Statement of Work (available [at/on](#) the [OHP](#) Section 232 Program website).
9. **Phase 1 ESA / HUD 4128.** Costs associated with any third party reports required to comply with Environmental Assessment and Compliance Findings (Form HUD-4128 [and HEROS-Form HUD 4128 as available](#)) requirements.
10. **Project Capital Needs Assessment (PCNA).** Costs associated with completion of a PCNA for projects requiring a PCNA as part of the Firm Application submission. The PCNA must be completed in compliance with the ORCF PCNA Statements of Work for Section 232/223(f) and Section 232/223(a)(7) or 232/223(f)/223(a)(7) (available [on/at](#) the [OHP](#)-Section 232 Program website).
11. **Financial/Placement Fee.** The Lender's fee limit is based on a percentage of the loan amount. The below table shows the limits for each OHP Section 232 Loan Program. The Lender's legal fees are included in the fee limit. Yield maintenance fees are not included in the fee limits. See Section 3.14 for fee limits for bond transactions.

	Fee Limit
232 New Construction	3.50%
232 Substantial Rehabilitation	3.50%
232 Blended Rate	3.50%
241(a)	3.50%
232/223(f)	3.50%

232/223(a)(7) or 232/223(f)/223(a)(7)	2%
223(d)	3.50%
232(i)	3.50%

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- 12. **Lender Legal.** Lender’s legal costs associated with the insured loan transaction. These fees combined with the Financial/Placement Fee are subject to the fee limits in Section 3.14.
- 13. **Borrower Legal.** Borrower’s legal costs associated with the insured loan transaction. Legal fees associated with zoning, land acquisition, environmental or other legal issues related to the land are not eligible for inclusion.
- 14. **Title & Recording.** The reasonable costs of obtaining a title insurance policy, title search and recording of closing documents. State or Local taxes associated with recording are also eligible for inclusion.
- 15. **Discounts.** Discounts paid by the Borrower for the FHA-insured loan.
- 16. **Bond Financing Costs.** Issuance costs associated with bond financing for the FHA-insured loan.
- 17. **Broker Fees.** Fees must be included in the Lender’s fee limits listed in Section 3.14. The broker must have experience in healthcare finance transactions and must have no identity-of-interest with any of the participants other than the lender itself.
- 18. **HUD fees associated with the transaction.** These include the Application Fee, Inspection Fee (if applicable) and Initial Mortgage Insurance Premium (MIP). Production, Chapter 2 describes the HUD fees for each of the OHP Section 232 Loan Programs.
- 19. **Survey.** Costs related to the HUD-compliant survey associated with the insured loan.
- 20. **Additional Other Fees.** The Lender must provide justification at the firm application stage that other fees are reasonable and necessary for the development or refinance/purchase of the project. Examples include non-legal costs to create the borrower entity and costs of maintaining books, records and tax information for the Borrower.

B. Additional Eligible Costs for New Construction, Sub-Rehab, Blended Rate and 241(a) Programs

- 1. **Land Purchase.** Purchase price of the site for the insured loan. A purchase contract or other evidence of the transaction must be provided. If the site was subdivided at the time of purchase, this must be discussed in the Lender Narrative.

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2. **Construction Contract Line Items.** These must be reflected on Construction Contract (Form HUD-92442-ORCF):
 - a. **Land Improvements.** Earthwork, site utilities, roads and walks, site improvements, lawns and planting, and unusual site conditions.
 - b. **Structures.**
 - c. **General Requirements.** Covers project-specific overhead expenses. Calculate as a percentage of the sum of Total Land Improvements and Total structures. Percentage amount is determined by the nature, difficulty and size of the project, and the characteristics of the neighborhood. The contractor shall provide a detailed cost breakdown of the items included in the general requirements.
 - d. **Builder's Overhead.** Covers contractor's head office and general business expenses. Amount is fixed at 2 percent of the sum of Total Land Improvements, Total Structures, and General Requirements.
 - e. **Builder's Profit.** Calculate as a percentage of the sum of Total Land Improvements, Total Structures, and General Requirements. Percentage amount is determined by the nature and location of the project.
 - f. **Bond Premium.** The bond premium covers Performance Bond. Used to ensure completion of construction in event of a default by the general contractor. Bonding company determines applicable rate by the nature and location of the project and the contractor's history. An irrevocable Letter of Credit may be used in lieu of a Performance Bond, provided it is unconditional, valid and collectable and issued by a banking institution.
 - g. **Contractor's Other Fees.** Costs of various required items and services. These can vary greatly from community to community. Examples of other fees include: building permits and licenses, builder's risk insurance, general contractor's cost certification audit fee, soil tests, concrete tests and other construction testing.
3. **Architect's Fees.** Architect's fees include both design and supervision costs. The architect's fees must match the Owner-Architect Agreement, AIA Form B108.
 - a. **Design.** Architect's Design Fee covers preparation of all construction documents (working drawings and specifications) up to start of construction. Typically 75 to 80 percent of total.
 - b. **Supervision.** Architect's Supervision Fee covers Architect's construction inspections, reports, and preparation of change order requests. Typically 20 to 25 percent of total.

NOTE: On new construction/sub-rehab, CON costs may be included in the total project cost, but it is not a mortgageable item. Therefore, CON costs can be counted toward the total equity on the project, but it is not cash equity in the form of reserves required to cover cash flow shortfalls during lease up.

- 191 C. **Interest Carrying Costs.** Interest on the amount of insured advances during the
192 construction period of the project is allowable as part of Replacement Cost. The Lender must
193 calculate the interest based on the proposed loan amount and interest rate over the proposed
194 construction period. The final amount allowed will be reviewed at cost certification.
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- 196 D. **Taxes.** Taxes associated with ownership of the property estimated on a per diem basis during
197 the construction period.
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- 199 E. **Insurance.** Insurance associated with the project estimated on a per diem basis during the
200 construction period, including:
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- 202 1. Builder's Risk Insurance (This must be part of the Contractor's General
203 Requirements OR under insurance),
 - 204 2. Liability Insurance,
 - 205 3. Officer's and Director's Insurance,
 - 206 4. Fidelity Bond Insurance,
 - 207 5. Vehicle Insurance (For owner or operator vehicles associated with the project),
 - 208 6. Business Interruption Insurance, and
 - 209 7. Additional necessary insurance.
- 210
- 211 F. **Market Study (including updates).** Costs associated with completion of the Market Study
212 as part of the Firm Application submission. The Market Study must be completed in
213 compliance with the ORCF Market Analysis Statement of Work (available [on](#) the [OHP](#)
214 Section 232 Program website).
215
- 216 G. **A&E / Cost Reports.** Costs associated with the completion of the Third Party Architecture
217 and Cost Reports. This includes the Geotechnical Report. The reports must be completed in
218 compliance with the ORCF Architecture and Cost Statement of Work (available [on](#) the
219 [OHP](#) Section 232 Program website).
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- 221 H. **Borrower's Cost Certification Audit Fee.** CPA Auditing Fee for the Cost Certification
222 Audit. This does not include the cost to set up the books and records, or to file tax returns.
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- 224 I. **Major Movable Equipment.** Large furniture and equipment with relatively fixed location,
225 but capable of being moved. Examples include: wheeled equipment, office machines (e. g.
226 computers, copiers, and fax machines), hospital beds and mattresses, tables, etc. Do not
227 include any motorized vehicles, such as trucks, vans, automobiles, or golf carts. These are
228 not mortgageable items. Do not include Minor Equipment and Supplies. Expendable non-
229 realty items of small individual cost. Examples: china and flatware, utensils and instruments,
230 linens, etc.
231
- 232 J. **Marketing.** Advertising, Salaries and Commissions of sales representatives, open houses,
233 model units, and other reasonable and necessary expenses associated with marketing the
234 project during the construction period. The Lender must assure that there are sufficient funds
235 available for marketing.

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K. Pre-Opening Management Fees. Production, Chapter 2.6 R describes Pre-Opening Management Fees.

K.L. Contingency Reserve. The contingency reserve amount is based on available data for the type and condition of structure. It is calculated as a percentage of the sum of structures, land improvements, and general requirements. Percentage ranges from 1% to 10%, depending on the condition of the project, extent of the rehabilitation, and experience and financial capacity of the borrower and contractor. The contingency reserve is only available for Substantial Rehabilitation and Blended Rate projects, and can only be used to cover unanticipated costs, such as discovering more extensive dry rot than was expected. The contingency reserve is not available for items such as an increase in cost of carpet.

L.M. Other Fees. Other Fees are those fees not outlined above, that are reasonable and necessary. Examples of other fees include the cost to create the books and records and file tax returns. Another example is relocation expenses. Relocation expenses must include a cost estimate with a proposed number of residents times the estimated cost per resident.

3.4

Section 232 New Construction

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The Maximum Insurable Loan is the lesser of the following:

- A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.
- B. **Amount Based on Replacement Cost (MILC Criterion C)**
 - 1. Multiply the Total Estimated Replacement Cost as calculated on the Replacement Cost (Repl Cost) tab of the MILC by 90%.
 - 2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land improvements and the unpaid balance of special assessments.
- C. **Amount Based on Required Loan-to-Value (MILC Criterion D)**
 - 1. Multiply the appraised value by the maximum LTV limit.
 - 2. Subtract from the product any of the following: the optional purchase price of leased land and the unpaid balance of special assessments.
 - 3. See Section 3.2 for maximum LTV limits.
- D. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**
 - 1. Divide the underwritten Net Operating Income (NOI) by 1.45.

- 279 2. Subtract from the quotient any of the following: the annual ground rent and the
280 annual special assessment.
281 3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate
282 (as calculated by the MILC Criterion E).
283 4. Add any annual tax abatement savings to the quotient.
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- 285 E. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for**
286 **Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, tax credits, the
287 optional purchase price of leased land, the cost of any excess unusual land improvements,
288 and the unpaid balance of special assessments from the Total Estimated Replacement Cost as
289 calculated on the Repl Cost tab of the MILC.
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3.5

Section 232 Substantial Rehabilitation

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293 The Maximum Insurable Loan is the lesser of the following:
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- 295 A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the
296 Firm Application.
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- 298 B. **Amount Based on Replacement Cost (MILC Criterion C)**
299
- 300 1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of
301 the MILC by 90%.
 - 302 2. Subtract from the product any of the following: the optional purchase price of leased
303 land, grant or loan funds attributable to replacement cost items, excess unusual land
304 improvements and the unpaid balance of special assessments.
305
- 306 C. **Amount Based on Required Loan-to-Value (MILC Criterion D)**
307
- 308 1. Multiply the appraised value by the maximum LTV limit.
 - 309 2. Subtract from the product any of the following: the optional purchase price of leased
310 land and the unpaid balance of special assessments.
 - 311 3. See Section 3.2 for maximum LTV limits.
312
- 313 D. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**
314
- 315 1. Divide the underwritten NOI by 1.45.
 - 316 2. Subtract from the quotient any of the following: the annual ground rent and the
317 annual special assessment.
 - 318 3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate
319 (as calculated by the MILC Criterion E).
 - 320 4. Add any annual tax abatement savings to the quotient.
321

322 E. **Amount Based on Estimated Cost of Rehabilitation Plus (MILC Criterion F)**
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- 324 1. Property Owned by Borrower: If the Borrower currently owns the property, start with
325 the lesser of: (i) 100% of the existing mortgage debt or (ii) 90% of the “as is” market
326 value of the property before rehabilitation (95% for Non-profit Borrowers).
327 a. Add to that amount the Total Estimated Development Cost as calculated on
328 the Repl Cost tab of the MILC.
329 b. Add to the sum the estimated offsite construction costs.
330 c. Subtract from the sum any grants or loans attributable to replacement cost
331 items listed on the Repl Cost tab of the MILC.
332
- 333 2. Borrower to Purchase Property: If the Borrower will purchase the property, start with
334 the lesser of: (i) ~~85~~90% of the purchase price of the property (~~95% for Non-profit~~
335 ~~Borrowers~~) or (ii) 90% of the “as is” market value of the property before
336 rehabilitation (95% for Non-profit Borrowers).
337 a. Add to that amount the Total Estimated Development Cost as calculated on
338 the Repl Cost tab of the MILC.
339 b. Add to the sum the estimated offsite construction costs.
340 c. Subtract from the sum any grants or loans attributable to replacement cost
341 items listed on the Repl Cost tab of the MILC.
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- 343 F. **Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for**
344 **Mortgageable Items (MILC Criterion L)**. Subtract any grants, loans, gifts, tax credits, the
345 optional purchase price of leased land, the cost of any excess unusual land improvements,
346 and the unpaid balance of special assessments from the Total Estimated Replacement Cost as
347 calculated on the Repl Cost tab of the MILC.
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3.6

Section 232 Blended Rate

The Maximum Insurable Loan is the lesser of the following:

- 353 A. **Requested Loan Amount (MILC Criterion A)**. This is the loan amount requested in the
354 Firm Application.
355
- 356 B. **Amount Based on Replacement Cost (MILC Criterion C)**
357
- 358 1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of
359 the MILC by 90%.
 - 360 2. Subtract from the product any of the following: the optional purchase price of leased
361 land, grant or loan funds attributable to replacement cost items, excess unusual land
362 improvements and the unpaid balance of special assessments.
 - 363 3. ~~—~~Add 100% of the existing indebtedness plus refinance costs if the property is
364 owned by the Borrower, or 85% of the purchase price plus transaction costs if the

borrower will purchase the property. ~~and~~ Round this figure down to the nearest \$100. To do this the Lender must revise the formula in the Criterion C conclusion cell.

C. Amount Based on Required Loan-to-Value (MILC Criterion D)

1. Blended Rate projects must use a blended LTV that takes into account the number of beds of each type (refinance and new construction).
2. Use the refinance LTV requirement for existing beds, and use the new construction LTV requirement for new beds.
3. For example, assuming a project has 77 existing beds and 39 new construction beds, the blended LTV is calculated as follows:
 - a. 77 beds multiplied by .8 (80% applicable to existing) = 61.6
 - b. 39 beds multiplied by .75 (75% applicable to New Construction) = 29.25
 - c. Total = 90.85
 - d. 90.85 divided by 116 (total # of beds) = Blended LTV of 78.3%
4. See Section 3.2 for maximum LTV limits.

D. Amount Based on Required Debt Service Coverage (MILC Criterion E)

1. Divide the underwritten NOI by 1.45.
2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

E. Amount Based on Estimated Cost of Rehabilitation Plus (MILC Criterion F)

1. Property Owned by Borrower: If the property is owned by the Borrower, start with the lesser of: (i) 100% of the existing mortgage debt or (ii) 90% of the “as is” market value of the property before rehabilitation (95% for Non-profit Borrowers).
 - a. Add to that amount the Total Estimated Development Cost as calculated on the Repl Cost tab of the MILC.
 - b. Add to the sum the estimated offsite construction costs.
 - c. Subtract from the sum any grants or loans attributable to replacement cost items listed on the Repl Cost tab of the MILC.
2. Borrower to Purchase Property: If the Borrower will purchase the property, start with the lesser of: (i) ~~85~~90% of the purchase price of the property (~~95% for Non-profit Borrowers~~) or (ii) 90% of the “as is” market value of the property before rehabilitation (95% for Non-profit Borrowers).
 - a. Add to that amount the Total Estimated Development Cost as calculated on the Repl Cost tab of the MILC.

452 5. Add any annual tax abatement savings to the quotient.

453
454 **E. Amount Based on Total Indebtedness (MILC Criterion I)**

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456 1. Multiply the “as proposed” market value by 90%.
457 2. Subtract from the product 100% of the total outstanding indebtedness related to the
458 property.

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460 **F. Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for**
461 **Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, and tax
462 credits, the optional purchase price of leased land, the cost of any excess unusual land
463 improvements, and the unpaid balance of special assessments from the Total Estimated
464 Replacement Cost as calculated on the Repl Cost tab of the MILC.
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3.8

**Section 232/223(f) Purchase or Refinancing
of a Residential Healthcare Facility**

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468 The Maximum Insurable Loan is the lesser of the following:

469
470 **A. Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the
471 Firm Application.

472
473 **B. Amount Based on Required Loan-to-Value (MILC Criterion D)**

- 474
475 1. Multiply the appraised value by the maximum LTV limit.
476 2. Subtract from the product any of the following: the optional purchase price of leased
477 land and the unpaid balance of special assessments.
478 3. See Section 3.2 for maximum LTV limits.

479
480 **C. Amount Based on Required Debt Service Coverage (MILC Criterion E)**

- 481
482 1. Divide the Lender’s underwritten Net Operating Income (NOI) by 1.45.
483 2. Subtract from the quotient any of the following: the annual ground rent and the
484 annual special assessment.
485 3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate
486 (as calculated by the MILC Criterion E).
487 4. Add any annual tax abatement savings to the quotient.
488

489 **D. Amount Based on Borrower’s Total Cost of Acquisition Section 223(f) (MILC Criterion**
490 **G).** Criterion G is only relevant if the 223(f) is a purchase transaction.

- 491
492 1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
493 2. Subtract from the Total HUD Eligible Costs any escrows or items the seller will pay

494 on behalf of the Borrower, as well as any grants or loans attributable to HUD Eligible
495 Costs.

496 3. Multiply the difference by 85% (90% for Non-profit Borrowers) of the purchase price
497 shown in the purchase agreement and determined allowable by the Lender.

498 **4. Rules for Eligible Costs on Purchase Transactions.**

499 a. The purchase price shown in the purchase agreement and determined allowable
500 by the Lender. If the Borrower is currently the Operator of the project and does
501 not have an identity of interest with the seller (see Handbook Introduction,
502 Chapter 1.6 C), subtract from the purchase price the cost of any improvements
503 that the Operator financed and the seller included in the purchase price.

504 b. If repair costs are included in the purchase price, do not itemize them as separate
505 HUD Eligible Costs.

506 c. The purchase agreement must specify whether the transfer includes any:

507 i. Escrows, and if so, the dollar amounts of those escrows.

508 ii. Items which the seller will pay on behalf of the Borrower, such as the
509 operating deficit, discounts, initial deposit to the R4R account, etc.
510

511 **E. Amount Based on Cost to Refinance (MILC Criterion H):** Criterion H is only relevant if
512 the 223(f) is a refinance transaction.

513 1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.

514 2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as
515 well as any grants or loans attributable to HUD Eligible Costs.

516 a. Any collateral held against the loan by the commercial Lender, other than
517 property-related assets, must be treated like R4R on deposit and subtracted
518 from the Total HUD Eligible Costs. This includes any additional collateral
519 held against the loan other than property related assets, including but not
520 limited to, R4R, escrows, restricted bank accounts, debt service reserves and
521 completion reserves.

522 b. Collateral to be subtracted from the Total HUD Eligible Costs does not
523 include: recourse or personal guarantees, or tax and insurance escrows. If the
524 Lender intends to include a recourse or personal guarantee in the eligible costs
525 basis, the Borrower will be required to certify that the collateral held against
526 the loan is property-related.
527

528 3. 100% of the difference is the eligible loan amount.
529

530 **F. Amount Based on Deduction of Grant(s), Loan(s), LIHTCs and Gift(s) for**

531 **Mortgageable Items (MILC Criterion L).** Subtract any grants, loans, gifts, and tax credits,
532 the optional purchase price of leased land, the cost of any excess unusual land improvements,
533 and the unpaid balance of special assessments from the Total Estimated Replacement Cost as
534 calculated on the Repl Cost tab of the MILC.
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3.9

Section 232/223(a)(7) or 232/223(f)/223(a)(7) Refinance of an Existing FHA-Insured Project

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The Maximum Insurable Loan is the lesser of the following:

- A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.
- B. **Original Principal Amount (MILC Criterion B).** This is the original principal amount of the existing FHA-insured mortgage.
- C. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**
 1. Divide the Lender's underwritten Net Operating Income (NOI) by 1.11.
 2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
 3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
 4. Add any annual tax abatement savings to the quotient.
- D. **Amount Based on the Cost to Refinance (MILC Criterion H):**
 1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
 2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as well as any grants or loans attributable to HUD Eligible Costs. HUD Eligible Costs for a 223(a)(7) refinance transaction are limited to costs listed in Section 3.3.
 3. Also subtract from Total HUD Eligible Costs any portion of the additional deposit to the R4R that is being paid from an interest rate premium.
 4. 100% of the difference is the eligible loan amount.

3.10

Section 223(d) Operating Loss Loan

567
568
569
570
571
572
573
574
575
576
577

The Maximum Insurable Loan is the lesser of the following:

- A. **Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the Firm Application.
- B. **Amount Based on Required Debt Service Coverage (MILC Criterion E)**
 1. Subtract the annual debt service (P&I+MIP) on the primary FHA-insured loan from the underwritten NOI.
 2. Divide the difference by 1.45.

- 578 3. Subtract from the quotient any of the following: the annual ground rent and the
579 annual special assessment.
580 4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate
581 (as calculated by the MILC Criterion E).
582 5. Add any annual tax abatement savings to the quotient.
583

584 **C. Amount Based on 100% of the Operating Loss (MILC Criterion J)** (as determined by an
585 independent audit certified by a CPA) and, if loan is pursuant to Section 223(d)(3), 80
586 percent of unreimbursed cash contributions (see Production Chapter 2, Section 2.11.B).
587

588 *The Operating Loss is defined as follows:* An Operating Loss is the difference between project
589 income and project operating expenses.
590

591 The following operating expenses may be included: taxes, interest on the mortgage debt,
592 mortgage insurance premiums, hazard insurance premiums, maintenance, salaries, supplies, and
593 other expense for project operation. The following payments and charges must not be included:
594 loan principal payments, depreciation, payments to the R4R account, payments to a sinking fund,
595 Lender's fees, charges incurred in connection with the application for the Operating Loss Loan
596 (OLL), projected anticipated losses, expenses that were funded or should have been funded from
597 the working capital deposit (e.g. tax and insurance escrows), construction cost overruns,
598 Officers' salaries, and bad debt or write-offs as a result of an identity of interest tenant.
599
600

3.11

Section 232(i) Fire Safety Equipment Loan

601
602 The Maximum Insurable Loan is the lesser of the following:
603

604 **A. Requested Loan Amount (MILC Criterion A).** This is the loan amount requested in the
605 Firm Application.
606

607 **B. Amount Based on Required Debt Service Coverage (MILC Criterion E)**
608

- 609 1. Subtract the annual debt service (P&I+MIP) on the primary loan from the
610 underwritten NOI.
611 2. Divide the difference by 1.11.
612 3. Subtract from the quotient any of the following: the annual ground rent and the
613 annual special assessment.
614 4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate
615 (as calculated by the MILC Criterion E).
616 5. Add any annual tax abatement savings to the quotient.
617

618 **C. Amount Based on 100% of the Cost of Fire Safety Equipment (MILC Criterion K).**
619 The sum of:
620

- 621 1. Cost and installation of fire safety improvements,
622 2. Related improvements, and
623 3. Eligible costs and fees. Eligible Mortgageable Costs for the 232(i) Fire Safety
624 Equipment Loan Program. The eligible costs include the cost and installation of the
625 fire safety equipment, related improvements (e.g. improvements to increase water
626 capacity) and the fees described in Section 3.3 A, specifically subsections: 8, 9, 10,
627 13, 17 and 18.
628
629

3.12

Tax Abatement

630
631 The loan amount may exceed the Debt Service Ratio limit by capitalizing the savings from tax
632 abatement. See Production, Chapter 5.5 for details regarding Tax Abatement.
633
634

3.13

Existing Indebtedness

635
636 National Housing Act Section 223(f)(4)(B) requires that proceeds of any refinancing will be
637 employed only to retire the existing indebtedness, and pay the necessary cost of refinancing of
638 the residential care facility. In order to ensure compliance with this statutory requirement, the
639 following guidelines are provided to assist in analyzing eligible existing indebtedness.

640
641 Existing indebtedness must meet the eligibility criteria outlined herein to be included as an
642 eligible mortgageable cost for ~~OHP-HUD~~ Section 232 insured mortgages. HUD does not permit
643 FHA-insured loan proceeds to be used directly for an equity takeout for ~~OHP~~ Section 232
644 transactions. -The following guidance applies to all Section 232 pursuant to 223(f)
645 refinances loan types except for Section 232/223(a)(7), Section 223(d) loans and Section 232(i)
646 Fire Safety Equipment Loan Program.

647
648 A. **Definition of Eligible Debt.** In order to be included as part of the ~~OHP~~ Section 232
649 mortgage, existing indebtedness ~~must be an obligation of the Borrower and directly~~
650 ~~connected to the project. Existing indebtedness must comply with the following provisions~~
651 ~~in order to~~ must meet the following FHA's requirements. The debt:

- 652
653 1. Must be existing indebtedness incurred in connection with the project,
654 ~~1.2.~~ Must not have been created with an Identity of Interest (IOI) between a Borrower
655 and the proposed FHA Lender, and
656 ~~2. Must not exceed existing project debt except for HUD allowed financing expenses,~~
657 ~~3. May include fully documented HUD-eligible and recent capital expenditures or~~
658 ~~structural repairs,~~
659 ~~4. Must not be used for funding operating expenses, and~~
660 ~~5.3.~~ Must not otherwise circumvent program intent.

661
662 Appendix 3.1 provides a visual description of the process required of Lenders in determining
663 the eligibility of existing indebtedness for the OHP Section 232 Loan Programs. When
664 required as outlined below, FHA Lenders conduct and document a Debt Investigation, which
665 is a review of existing loan and indebtedness documentation to demonstrate the debt
666 complies with these provisions.—
667

668 B. **Categories of Eligible Debt.** When demonstrating the eligibility of existing
669 indebtedness, the FHA Lender must provide satisfactorily documented evidence that
670 the existing debt incurred by the Borrower (or its principals) in connection with the
671 project conforms to one of the categories below:
672

- 673 1. **Outstanding mortgage(s).** Outstanding mortgage(s) ~~incurred in connection~~
674 ~~with the construction or purchase of the project, or incurred in connection~~
675 ~~with HUD eligible capital improvements made to on the property~~ project as
676 confirmed and fully documented by the current Lender.
677
- 678 2. **Other Recorded Indebtedness.** Other recorded indebtedness ~~on the~~
679 ~~property~~ in connection with the project incurred by the Borrower pursuant to
680 the normal course of business may be considered. Examples include, but are
681 not limited to, mechanic's liens, tax liens and past due assessments provided
682 they did not result from personal obligations of the Borrower principals. Note
683 that operator agreements with the former owners that do not appear to be
684 arm's length or with abnormally high lease cost arrangements need to be
685 thoroughly analyzed.
686
- 687 3. **Unrecorded Debt.** Unrecorded debt of, or costs incurred in connection with
688 the project and supported by, the Borrower that is directly connected to the
689 project and supported by documentation satisfactory to HUD may be
690 considered eligible debt. The ~~Borrower must provide the~~ Lender must be
691 provided with documentation and a certification that verifies the obligation is
692 directly connected to the project. In instances where there are the case of costs
693 incurred, ~~the~~ is documentation ~~would~~ include invoices, payment
694 documentation, photographs, and a description of the work done. This
695 includes indebtedness or costs incurred to make HUD eligible capital
696 improvements expenditures, structural repairs and betterments to the property.
697
- 698 4. **Operator Debt.** Certain Operator debt tied directly to the project and
699 supported by documentation satisfactory to HUD may be considered eligible.
700 Examples include costs related to the purchase of additional furniture fixtures
701 and equipment, working capital related to lease-up and stabilization of the
702 project and other capital expenditures. Costs associated with an accounts
703 receivable line of credit will not be considered eligible. Costs related to
704 acquiring bed authority or Certificate of Need will not be considered eligible
705 on refinances.

706
707 CON costs may be included in the total project cost, but it is not a mortgageable
708 item. Therefore, CON costs can be counted toward the total equity on the
709 project, but it is not cash equity in the form of reserves required to cover cash
710 flow shortfalls during lease up.

711
712 **4.5. Reserves held by Current Lender.** Escrows and reserves comprising any additional
713 property-related collateral held by the current Lender against the loan, but then
714 released at some point after initial funding of the loan will only be considered eligible
715 if:

- 716 a. The loan comprising the existing indebtedness meets eligible debt and debt
717 seasoning requirements,
- 718 b. The release provisions for the funding of the current loan were ~~clear and pre-~~
719 ~~defined~~predetermined at the time the original loan was made, and
- 720 c. The escrow is released before the FHA Lender makes application to HUD for
721 ~~the loan~~mortgage insurance.

722
723 Any reserves not meeting these criteria will be treated like R4R on deposit and
724 subtracted from the Total HUD Eligible Costs pursuant to MILC Criterion H.

725
726 An example of the Current Lender holding back escrows or compensating balances is:

727
728 A commercial Lender makes a loan for \$8M, but increases the amount of the Note to
729 \$8.5M by holding an escrow of \$500,000 (funded by the Borrower) to collateralize the
730 increased amount. The Lender reports outstanding debt of \$8.5M, but with HUD costs of
731 \$500,000, the total eligible costs are \$9M and HUD insures a loan for \$9M. The
732 commercial Lender then releases the escrow to the Borrower when the commercial loan
733 is paid off. This results in the Borrower receiving equity cash out from FHA-insured loan
734 proceeds and would not be permissible .

735
736 **5.6. Other Eligible Costs.** Examples of other eligible costs associated with paying off the
737 eligible debt are:

- 738 a. Reasonable, non-delinquent accrued interest to a non-IOI party,
- 739 b. ~~Reasonable p~~Prepayment penalties on the mortgage loan and program
740 penalties arising from the defeasance (or yield maintenance) of conventionally
741 – financed loans, in an amount not to exceed 10% of the proposed mortgage
742 loan amount. Further, the costs of settling prepayment penalties associated
743 with swaps or other derivatives (i.e. swap breakage fees) are generally not
744 eligible to be included in the calculation of existing indebtedness, except
745 where expressly allowed by HUD-issued guidance,
- 746 c. Recording, release, and re-conveyance fees, and
- 747 d. Documentation or processing fees.

748
749 NOTE: Program penalties arising from the defeasance of tax-exempt and taxable
750 bonds cannot be recognized. Defeasance costs associated with underlying bond

751 financing, yield maintenance, swap termination fees, or costs to satisfy similar
752 derivative instruments will only be recognized in the eligible cost basis up to 10% of
753 the requested FHA loan amount. The costs of settling prepayment penalties associated
754 with swaps or other derivatives (i.e. swap breakage fees) are generally not eligible to
755 be included in the calculation of existing indebtedness, except where expressly
756 allowed by HUD issued guidance.

757
758 **C. Debt Investigation.** Instance which trigger a debt investigation - HUD requires a debt
759 investigation of the existing indebtedness when:

- 760 1. The creation of the debt involved an IOI Lender,
- 761
- 762 2. The current loan was created less than two years ago,
- 763
- 764 3. Circumstances are present that indicate the previous financing may have
765 included other forms of non-standard collateral that suggest the debt was not
766 created in an arms-length transaction,
- 767
- 768 4. The current loan involved alternate financing structures (e.g., pooled debt, line-
769 of-credit financing, and mezzanine debt) and requires further explanation, as
770 deemed necessary by HUD,
- 771
- 772 5. The current Lender held escrows or compensating balances that will be released
773 back to the Borrower, or
- 774
- 775 6. Any other non-traditional debt or atypical obligations/interests/agreements
776 are involved.
- 777
- 778

779 The following are the types of documentation that may be provided to substantiate the
780 eligibility of existing indebtedness when a debt investigation has been conducted:

781 Fully executed mortgage note, settlement statement, payoff statement, purchase & sale
782 agreement, purchase contract, option agreement, allonge, capital invoices, fully documented
783 title search, title exceptions, release documentation and other updated loan documents.

784
785
786 If the debt is more than two years old and the FHA Lender has adequately addressed all IOIs,
787 the FHA Lender can submit the firm application, subject to HUD's review, underwriting and
788 final approval. HUD, however, reserves the right to request that the FHA Lender conduct a
789 debt investigation on debt created more than two years prior to firm application.

790
791 **E.D. Debt Seasoning.** Debt seasoning is a minimally required period of time between
792 the closing date of a loan and the date that an application to refinance the existing debt is
793 submitted to HUD. HUD uses debt seasoning as a period of time for the project to
794 demonstrate its ability to generate thea sufficient level of cash flow to support the value
795 and pay debt service (These provisions do not alter the requirements of 24 CFR Sec.

232.902 where otherwise applicable). The seasoning time frame for prospective Borrowers (and their principals and affiliates) is also used to ensure that the mortgage debt does not circumvent the program's prohibition against cash out refinancing. When the FHA Lender cannot provide evidence that the existing indebtedness was used for an eligible purpose as outlined above, ORCF requires a 2-year waiting period from the time the existing debt was generated (loan closing) and the date the firm application for FHA-insured financing is submitted to HUD.

The below matrix will be used in determining debt seasoning. All debt must be in place prior to the submission of the firm application.

<u>% of Existing Debt Used for Project Purposes</u>	<u>Requested FHA Loan Amount <=60% LTV</u>	<u>Requested FHA Loan Amount 61% - 70% LTV</u>	<u>Requested FHA Loan Amount >= 71% LTV</u>
<u>> 50%</u>	<u>Application may be submitted within 2 years</u>	<u>Application may be submitted within 2 years</u>	<u>2 year seasoning applies</u>
<u><= 50%</u>	<u>Application may be submitted within 2 years</u>	<u>2 year seasoning applies</u>	<u>2 year seasoning applies</u>

Consideration for less than two years seasoning requires value supported by a 3rd party appraisal and 3+ years of stabilized historical cash flow which supports the value. Additionally, an ORCF appraisal review will be required.

D.E. Identity of Interest Lenders. An Identity of Interest (IOI) is defined in Handbook Introduction, Chapter 1.6. In addition to determining if the existing debt will be subject to additional underwriting mitigants, as outlined above, required to season for the two-year period, the FHA Lender must fully disclose and examine any IOIs involving the Borrower or Lender. In the event that it is determined that an IOI exists, the FHA Lender's valuation of the project must be thoroughly analyzed by HUD pursuant to the following: identify and examine any IOIs involving a Lender.

1. IOI between Borrower and Current Lender. A Debt Investigation is required if there is an IOI between the Borrower and current Lender in a banking relationship. HUD permits a Lender to provide bridge loan or other financing to a client and later submit an application for mortgage insurance to HUD. However the relationship will require that HUD thoroughly investigate the bridge loan or other similar loan transactions with the IOI party to insure that the loan meets HUD's requirements.

826
827 ~~2. **IOI between FHA Lender and Current Lender.** The proposed FHA Lender must~~
828 ~~fully disclose any IOI it has with the current Lender of the existing indebtedness. The~~
829 ~~FHA Lender's valuation of the subject property must be thoroughly analyzed by~~
830 ~~HUD pursuant to the following:~~

- 831 1. The documentation supports that the project is valued at fair market value,
832
833 2. The transaction must not include other forms of non-standard FHA collateral
834 that suggest the project-related debt was inflated or included costs that
835 overstated arms-length project debt, and
836
837 ~~3.~~3. Evidence provided to support that the debt meets the debt seasoning
838 requirements outlined above.
839

840 **E.F. Review of Recent Indebtedness Involving a Purchase.** If the outstanding debt was
841 generated less than two years ago and involved a purchase, HUD will require a review of
842 existing indebtedness.~~still need to review the refinance transaction, even if no cash was~~
843 ~~taken out:~~
844

845 **1. Identity of Interest (IOI) Purchase.** A transaction is considered to be an IOI
846 purchase when there is any IOI (as defined in Section I, Introduction, Chapter 1.6)
847 between the seller and purchaser that survives a sales transaction, or when a partner
848 buys out the interest of another partner or member of the borrowing entity. Under
849 these circumstances, the documented existing indebtedness used to effectuate such a
850 transaction may be immediately eligible as provided below:~~debt must season for two~~
851 ~~years in order to be considered eligible. Also, since the seasoning requirement will~~
852 ~~require the firm application to be submitted after the date of the transaction, it must~~
853 ~~also be processed as a refinance pursuant to Section 3.8 above.~~

- 854 a. The seller has no residual rights to control the project.
855 b. The seller has no residual rights to reacquire the project until not less than
856 five years of the HUD closing, otherwise the HUD loan will need to be paid
857 off,
858 c. The purchase must have occurred prior to the date on which the firm
859 commitment was issued.
860

861 **2. Identity of Interest (IOI) Refinance.** A transaction is considered to be an IOI
862 refinance when a portion of the debt to be refinanced with the FHA mortgage was
863 created by a person or entity with an IOI to the borrower (e.g. partnership debt).
864 Examples of this situation include transactions completed below market value due to
865 a pre-negotiated purchase price or a quick turnaround of a previously
866 underperforming project. Existing indebtedness used to effectuate such a transaction
867 may be eligible subject to the following:

- 868 a. A minimum of 12 months (under the new operator) demonstrated net
869 operating income (NOI) that supports the requested mortgage amount,

- 870 b. For turnarounds, the operator must have a proven track record of successful
871 turnarounds and maintaining operations. In support, the FHA Lender will
872 provide in the Lender Narrative documentation from other similar project
873 operations, including :
874 i. Project name and address
875 ii. For a time period (3 or more years) including before, during and after
876 transition to the new operator:
877 1. Revenue
878 2. NOI
879 3. Number of beds or residents or units
880 4. Occupancy
881

882 Additionally, an ORCF appraisal review is required.
883

884 **2.3.Sale-leaseback transactions.** An Owner-Operator that sells its interest in a project,
885 but continues to operate the project after the sale is generally considered an IOI
886 purchase as outlined immediately above. If the selling entity continues to operate the
887 project after the transaction, it will NOT be considered an IOI purchase when the
888 following conditions are met:

- 889 a. The transaction was completed at arms-length,
890 b. The sales transaction was completed at market value (ORCF-approved
891 full appraisal review),
892 c. The operating lease is a typical market rate lease transaction between
893 the old owner and the new owner,
894 d. Documentation of organizational structures clearly indicates that there
895 is no IOI between or among individuals actually involved on both
896 sides of the transaction, and
897 e. The seller has not taken back any note and has no residual rights to
898 reacquire the project.
899

900 Such transactions that meet the sale-leaseback criteria may be processed as a
901 purchase, as long as the firm application is submitted prior to the date of the
902 transaction.
903

904 ~~F. **Debt Investigation.** HUD requires a Debt Investigation of the existing indebtedness when:~~

- 905
906 ~~1. The creation of the debt involved an IOI Lender,~~
907 ~~2. The current loan was created less than two years ago,~~
908 ~~3. Circumstances are present that indicate the previous financing may have included~~
909 ~~other forms of non-standard collateral that suggest the debt was not created in an~~
910 ~~arms-length transaction,~~
911 ~~4. The current loan involved alternate financing structures (e.g., pooled debt, line of~~
912 ~~credit financing, and mezzanine debt) and requires further explanation, as deemed~~
913 ~~necessary by HUD,~~
914 ~~5. The current Lender held escrows or compensating balances that will be released back~~

915 to the Borrower, or
916 6. ~~Any other non-traditional debt or atypical obligations/interests/agreements are~~
917 ~~involved.~~

918
919 An example of the Current Lender holding back escrows or compensating balances is:

920
921 ~~A commercial Lender makes a loan for \$8M, but increases the amount of the Note to~~
922 ~~\$8.5M by holding an escrow of \$500,000 (funded by the Borrower) to collateralize the~~
923 ~~increased amount. The Lender reports outstanding debt of \$8.5M, but with HUD costs of~~
924 ~~\$500,000, the total eligible costs are \$9M and HUD insures a loan for \$9M. The~~
925 ~~commercial Lender then releases the escrow to the Borrower when the commercial loan~~
926 ~~is paid off. This results in the Borrower receiving equity cash out from FHA-insured loan~~
927 ~~proceeds and would violate program intent.~~

928
929 The following are the types of documentation that may be provided to substantiate the
930 eligibility of existing indebtedness when a Debt Investigation has been conducted:

931
932 ~~Fully executed mortgage note, settlement statement, payoff statement, purchase & sale~~
933 ~~agreement, purchase contract, option agreement, allonge, capital invoices, fully~~
934 ~~documented Title Search, Title Exceptions, release documentation and other updated loan~~
935 ~~documents~~

936
937 ~~If the debt is more than two years old and the FHA Lender has adequately addressed all IOIs,~~
938 ~~the FHA Lender can submit the firm application, subject to HUD's review, underwriting and~~
939 ~~final approval. HUD, however, reserves the right to request that the FHA Lender conduct a~~
940 ~~Debt Investigation on debt created more than two years prior to firm application.~~

941
942 **G. Alternate Financing Structures.** HUD recognizes that it is commonplace for
943 conventional Lenders to use various alternate financing structures to finance the
944 construction, purchase, rehabilitation or refinancing of one or more projects. The
945 guidance in this subpart addresses some of these financing structures. Please note
946 that the inherent complexity of alternative financing structures requires explanation
947 by the Lender and may require a Debt Investigation by the FHA Lender (as indicated
948 in 3.13 F above), or an in-depth review by ORCF.

949
950 **1. Bridge Loans.** A bridge loan is a loan that is short term in nature that allows
951 a Borrower to borrow short term funds to bridge a gap between the repayment
952 of the previous loan or financing structure (or a purchase) and permanent
953 financing such as an FHA-insured loan. Bridge loans are subject to debt
954 seasoning, identity of interest lenders and review of recent indebtedness
955 requirements as outlined in [Section 3.13 A](#), [Section 3.13 B](#), [Section 3.13 C](#),
956 [Section 3.13 D](#) and [Section 3.13 E](#).

957 **a.** The bridge loan itself does not need to season for two years if the
958 amount of the bridge loan is equal to the outstanding principal amount
959 of the previous loan, and there was no equity cash out to any

960 individual or entity.

961 b. As incentive for lower risk loans to seek FHA financing, two-year seasoning
962 may not apply based on a combination of LTV and the portion of the bridge
963 loan that consists of outstanding principal amount of a previous loan. If the
964 bridge loan includes payoff of outstanding principal from an arms-length loan
965 and/or other proceeds, then the full amount of the bridge loan is eligible for an
966 FHA loan within two years as long as it meets the criteria in the above Section
967 3.13D.:

968
969 A Debt Investigation ~~would only~~will be required when the total timeframe of
970 the two previous loans, the outstanding project loan and the short term bridge
971 loan, is less than 24 months.

972
973 **4.2. Portfolio Indebtedness (Pooled Debt).** It is normal industry practice for
974 conventional Lenders to finance multiple projects using a single cross-collateralized
975 financing mechanism, or various “pooled” financing structures, such as CMBS (a
976 Commercial Mortgage Backed Security). Typically, both HUD and the Current
977 Lender require that the FHA Lender obtain a partial release from the Current Lender
978 to “pull” the project seeking HUD financing out of the existing pooled credit facility.
979

980 Absent a partial release, HUD expects the FHA Lender to document the amount of
981 the existing debt related to each project proposed for an FHA-insured mortgage, or to
982 otherwise substantiate that all the subject projects are liable for all the outstanding
983 notes that will be paid off with FHA-insured mortgage proceeds. For portfolio
984 transactions, the Lender shall specify if any debt is non-project related and provide a
985 reasonable allocation of total debt between non-project and project-related debt. For
986 example, a large transaction may also include certain non-project subsidiaries such as
987 rehabilitation firms, operating entities, hospices, corporate office buildings or other
988 non-project facilities or entities. FHA Lenders must adhere to the following guidance
989 for analyzing and investigating portfolio indebtedness if the partial release
990 information is not available:

- 991 a. The FHA Lender must perform Debt Investigation and submit to HUD
992 documentation that substantially connects the proposed project to the
993 outstanding indebtedness (See Section 3.13 F above).
- 994 b. HUD expects eligible debt will be allocated (both individually and
995 collectively) using one of the following methods which can be demonstrated
996 to bear a direct relationship to the existing indebtedness:
- 997 i. **Allocation of Debt.** An allocation of debt based on ORCF-compliant
998 appraisals for all the projects covered by the existing debt is the
999 preferred allocation method. To calculate, add up the approved values
1000 for all the projects and divide the total debt by the sum of the values.
1001 Multiply the result by a project’s value to determine the amount of
1002 existing indebtedness to be assigned to a project.
- 1003 ii. Lenders may develop other options for assigning debt, such as debt
1004 based on number of beds, number of units, percentage of revenue or

1005 percentage of overall NOI. However, all are subject to ORCF review,
1006 and approval will be considered on a case-by-case basis and appraisals
1007 must support the proposed value.

- 1008 iii. **Reallocation of Debt.** When existing notes have specific mortgage
1009 amounts for each project, absent a partial release, any reallocation of
1010 debt based on appraised value or an alternative approach must be
1011 approved by HUD and the current Lender. The FHA Lender must
1012 submit evidence that the loan documents and terms have been
1013 amended, extended, allonged or otherwise modified prior to the
1014 submission of firm application. Otherwise, HUD will only approve a
1015 reallocation of debt that is substantially demonstrated to conform to
1016 program intent and *not* involve equity takeout. Reallocation of debt is
1017 acceptable when project values have changed over time, but in all
1018 cases, the changes in value must be defensible on the merits of the
1019 valuation.

1020
1021 **2.3. Line-of-Credit Financing.** HUD will consider as eligible line-of-credit indebtedness
1022 attributable to HUD eligible acquisition costs, capital repairs and improvements. It is
1023 permissible for the line-of-credit financing to be initiated to reimburse the person or
1024 entity that financed the costs (e. g. reflect a loan made to the project to repay the
1025 parent corporation that purchased it with cash or another source of equity), so long as
1026 the reimbursed costs are traceable to the project and it meets the requirements for
1027 HUD eligible costs. All such transactions, must comply with the following:

- 1028 a. HUD will recognize line-of-credit portfolio indebtedness attributable to HUD
1029 eligible acquisition costs, capital repairs and improvements that are fully
1030 documented. If the project debt is currently pooled with debt from other
1031 properties, the FHA Lender must obtain a partial release of the portion of the
1032 indebtedness being brought in for an FHA-insured mortgage and demonstrate
1033 that the HUD eligible debt allocated to the project is fair and reasonable.
1034 b. Absent a stated release amount, the eligible debt amount will be determined
1035 following Section 3.13 G 2.
1036 c. When the line-of-credit indebtedness reflects reimbursed acquisition costs that
1037 exceed 15 percent of the purchase price, the Borrower must also submit a
1038 report from an independent CPA of the cash or equity payment incurred for
1039 the project. The report must be attached to a cover letter, signed and dated by
1040 an authorized officer of the borrower entity, which attests to the accuracy of
1041 the CPA's report, with the Section 1010 Criminal warning clearly set forth.

1042
1043 ~~3.4. Two-Year Look Back for REITs. HUD has determined that REITs may not be~~
1044 ~~required to initiate line-of-credit financing to establish existing indebtedness. This is~~
1045 ~~because REITs make arm's length business decisions to purchase, construct or~~
1046 ~~acquire projects using investor contributions, cash or equity instead of debt. The~~
1047 ~~Two-Year Look Back provision will reduce the administrative burden of initiating a~~
1048 ~~line of credit for the purposes of being paid off with FHA insured mortgage proceeds~~
1049 ~~pursuant to the following: REITs. HUD has eliminated the Two-Year Look Back~~

1050 [policy for REITs as previously described in the May 22, 2014 version of this](#)
1051 [Handbook. In a refinance pursuant to National Housing Act Section 223\(f\), all REITs](#)
1052 [are required to demonstrate debt such as through a line-of-credit financing \(see above](#)
1053 [Section 3.13 G 3 for the requirements for line-of-credit financing\).](#)

- 1054 a. ~~REITs that completed purchase transactions within two years of the date of~~
1055 ~~application may be treated as a special instance of a purchase transaction~~
1056 ~~when the following conditions are met:~~
- 1057 i. ~~The purchase price only includes HUD eligible costs,~~
 - 1058 ii. ~~The transaction was completed at arms length,~~
 - 1059 iii. ~~The sales transaction was completed at market value (ORCF approved~~
1060 ~~appraisal), and~~
 - 1061 iv. ~~Documentation of organizational structures clearly indicates that there~~
1062 ~~is no IOI between or among individuals actually involved on both~~
1063 ~~sides of the transaction.~~
- 1064 b. ~~For purchase transactions meeting the Two Year Look Back provision~~
1065 ~~criteria, the maximum insurable loan will be determined by the loan sizing~~
1066 ~~criteria outlined in the MILC (see Sections 3.4—3.8 above), but cannot~~
1067 ~~exceed 80% of ORCF appraised value or the cost of the acquisition. When~~
1068 ~~determining the maximum insurable loan based on MILC Criterion G, the~~
1069 ~~FHA Lender must use the Rules for Eligible Costs on Purchase Transactions~~
1070 ~~(see Section 3.8 D).~~
- 1071 e.a. ~~REITs not meeting these Two Year Look Back criteria will~~ They will be
1072 required to demonstrate debt, such as through a line-of-credit that covers
1073 reimbursed acquisition costs, like other corporate entities and to apply as a
1074 refinance transaction.

1075
1076 **4.5. Mezzanine Debt.** Mezzanine debt is hybrid debt where one debt issue is
1077 subordinated to another debt issue. Typically, mezzanine debt is provided by a
1078 private lending source and can be secured ~~as a second mortgage debt~~, a pledge of
1079 partnership equity interests, a pledge of other assets and/or personal guarantees. The
1080 provisions limiting eligibility only apply when the debt is secured with a pledge of
1081 partnership equity interests. Mezzanine debt may have embedded equity instruments
1082 and profit sharing mechanisms included, which increase the net present value of the
1083 subordinated debt to the mezzanine holders. ~~These features allow for greater~~
1084 ~~flexibility in dealing with Lenders, and are often used for acquisition and buyout~~
1085 ~~transactions.~~ The existence and terms of all mezzanine debt must be fully disclosed
1086 and approved by HUD during the application process. Mezzanine debt will only be
1087 considered in the eligible basis for refinancing when:

- 1088 a. There is no IOI between the principals and the mezzanine Lender or any of its
1089 affiliates,
- 1090 b. The loan documents associated with the mezzanine financing clearly identify
1091 the debt as directly funding the costs of the property and of any HUD eligible
1092 improvements, and
- 1093 c. Any equity contributions made as part of the mezzanine financing are
1094 memorialized in a Note and reflected on a balance sheet as a liability.

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The Borrower must “settle up” on any contributions for a fixed amount, and the difference between the amount of the contribution and the total payments made to the entity could be treated as existing indebtedness. Any mezzanine debt that remains from a previous financing of the property is subject to the secondary financing guidance for private sources (See Section 3.15 below) and will subordinate to HUD’s first lien interest.

3.14

Bond Financing

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A. Review of Financing Documents. A tax-exempt bond is a security issued by a governmental agency in which the interest income produced is free from federal income tax and sometimes free from state and/or local income tax. Financing documents associated with mortgage bonds or tax-exempt bonds are prepared and reviewed by the bond underwriter and the bonds are secured by a mortgage on one or more assets. In FHA-insured transactions, these bonds are backed indirectly by an interest in the insured loan which is further enhanced by a GNMA Security.

The Lender must submit, with the application for commitment processing, a separate statement itemizing the estimated costs of bond issuance, issuer fees and discounts and financing fees to be paid out of pocket by the Borrower/participant with an explanation of the necessity and reasonableness of each cost. The Lender’s underwriter must check the statement for reasonableness, using the data from previously processed bond-financed projects and make adjustments where appropriate.

B. Loan Rates.

1. The construction loan and the permanent loan rates may exceed the interest rate on the bond obligations. When this occurs, the spread will create a surplus of funds which must be held by the bond trustee. At initial closing, the bond counsel must supply ORCF with a legal opinion stating that any investment income received by the Lender but not held for its own account must be under the control of the bond trustee and will not flow through the books and records of the project. The bond documents will instruct the trustee to invest the funds in a federally insured interest bearing account, submit annual statements with the project financial statement, or the Borrower may use the surplus of funds to cover costs associated with the bond financing transaction but not recognized in traditional ORCF processing.

2. In many cases, the interest rate on the bonds will not be known during the commitment processing and it is not uncommon for the rate to change once the bonds have been sold and the bond interest rate has been established. If the interest rate changes, an amendment to the Firm Commitment must be requested by the Lender

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reflecting the actual interest rate. If due to time constraints, ORCF does not have sufficient time to reprocess a higher loan for the project:

a. The Firm Commitment must contain the following condition:

“Any interest savings resulting purely from a differential between the ORCF processed interest rate and the actual final interest rate should be identified in a footnote and should not be included in interest cost in the Borrower’s cost certification submission. Interest savings will not be viewed by ORCF as an allowable cost.”

b. However, savings resulting from the early completion of construction must be reflected in interest cost in the Borrower’s cost certification. Compute interest savings by:

- i. Recalculating the estimated interest line item on the MILC Replacement Cost Tab, using the actual interest rate for the scheduled construction period.
- ii. Subtracting the actual interest cost recognized at cost certification from the revised interest figure developed in (1) above.

3. ORCF will allow a total financing and placement fee of 5.5% on bond financed applications. This limit applies to all Section 232 projects except Section 223(a)(7) mortgages and is reflected in the cost amount confirmed at cost certification.

1160 C. Fee Limits:
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Section 232 Loan Program	Bond Transaction Fee Limit
232 New Construction	5.50%
232 Substantial Rehabilitation	5.50%
232 Blended Rate	5.50%
241(a)	5.50%
232/223(f)	5.50%
232/223(a)(7) or 232/223(f)/223(a)(7)	4%

1163
1164 D. Bonds may be sold at a premium to investors, whereby the investor pays an amount in excess
1165 of the face value of the bonds. The premium results from the bonds carrying a higher coupon
1166 rate than is generally available in the marketplace.

- 1167
- 1168 1. Any premium raised by a transaction is considered part of the Lender, bond
1169 underwriter, or issuer's profit. The one exception involves tax-exempt bond
1170 transactions where the issuer of the bonds may permit the Borrower to receive some
1171 portion of the premium to offset the cost of issuance so that the Lender, bond
1172 underwriter and issuer are simply conduits for the transfer of funds.
1173
 - 1174 2. If any portion of the premium is returned to the Borrower, it will be treated as a
1175 Windfall for Section 232 new construction, Section 241(a) and blended rate projects,
1176 reflected in the Windfall calculation for substantial rehabilitation projects, and
1177 transferred to the R4R account for Section 232/223(f) projects. Details on the
1178 Windfall calculation can be found in Production, Chapter 11.

1179
1180 Closing documents must detail the amount of the premium being given to the
1181 Borrower or the borrower entity it controls. The Borrower's accountant for an
1182 audited cost certification, or the Borrower for an unaudited cost certification, must
1183 detail in the notes to the financial statement the amount of premium received.
1184

1185 E. Itemized Statement of Costs. Attached to and reflected in the Lender Certification (Form
1186 HUD-92434-ORCF), is an itemized statement of the costs of issuance of the obligations,
1187 discounts and financing fees paid through the Lender.

- 1188
- 1189 1. The statement must explain why each individual item is necessary for the issuance of
1190 the obligations.
1191
 - 1192 2. The Lender must review the amount of each item to ensure its reasonableness in
1193 relation to comparable projects.

1194

- 1195 3. The Lender, bond underwriter, and issuer have the option of deferring collection of
1196 additional discounts, financing fees slow draw fees, etc. in accordance with the
1197 provisions of the Lender Certification.
1198 a. The deferred collection of these items must be an obligation of a third party.
1199 Both the third party and the Lender, bond underwriter or issuer must attest in
1200 writing that they will not look for payment from the:
1201 i. Borrower,
1202 ii. Mortgaged property,
1203 iii. Loan proceeds,
1204 iv. Any reserve or deposit required by ORCF and/or the Lender in
1205 connection with the insured loan transaction, or
1206 v. Rents or other income from the mortgaged property.
1207 b. The borrower entity may issue, as evidence of the debt, surplus cash or
1208 residual receipts note to the third party for costs identified in this paragraph
1209 which ORCF determines to be reasonable.
1210

1211 F. State and Local Bond Financed Projects.
1212

- 1213 1. Prepayment of Note. Must include the following prepayment restrictions and
1214 prepayment penalty charges:
1215 a. Prepayment restriction period (lockout) must not exceed 10 years plus the
1216 construction period stated in the Construction Contract, or, in the alternative,
1217 must not exceed 10 years from the commencement of amortization, and
1218 b. Prepayment penalty may be charged after expiration of the lockout provided
1219 the charge:
1220 i. During the first year following the lockout does not exceed 5% of the
1221 original mortgage,
1222 ii. Declines on a graduated basis (to the extent practicable, the decline in
1223 the penalty percentage should be the same each year), and
1224 iii. Does not exceed 1% at the end of the fifth year following the lockout.
1225
1226 2. State/Local Occupancy, Use and/or Rent Restrictions. Use or rent restrictions sought
1227 by the State or local jurisdiction for projects financed by proceeds from State/local
1228 tax-exempt obligations are often more restrictive than the minimum requirements of
1229 the Internal Revenue Code. ORCF may approve a State or local restriction exceeding
1230 the minimum requirements of the Internal Revenue Code, but only if the following
1231 conditions are met:
1232 a. ORCF must determine that the restriction is not likely to have an adverse
1233 impact on project occupancy, marketability or long-term feasibility. This
1234 determination must be made on a project-by-project basis.
1235 b. The restriction must not conflict with any applicable ORCF mortgage
1236 insurance regulations or related administrative requirements.
1237 c. The restriction must not appear in the Note, Mortgage, Regulatory Agreement
1238 or any other ORCF mortgage insurance document.

- 1239 d. The restriction must be qualified to provide that it will automatically terminate
1240 in the event of foreclosure or transfer of title by deed in lieu of foreclosure.
1241 Such a termination provision must be included in every legal instrument (e.g.,
1242 deed, land use restriction agreement, Security Agreement, or financing
1243 agreement) in which the restriction appears.
1244
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3.15

Secondary Financing

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1247 The amount, form, terms and conditions of any permitted secondary financing is based on the
1248 source of funding, as follows:
1249

A. When secondary financing is from a Federal, State or Local Governmental Source:

- 1250
1251
1252 1. The secondary financing may be on a form of promissory note and secured by a
1253 mortgage lien as is prescribed by the governmental funding source and reviewed and
1254 approved by ORCF.
1255
1256 2. Secondary financing or grants lent to the property as a secondary loan may be used to
1257 cover up to 100% of the applicable Section of the Act equity requirements.
1258
1259 3. Secondary financing or grants lent to the property as a secondary loan may also be used
1260 to finance non-mortgageable costs, and when added to the FHA-insured loan and
1261 required equity contribution, may exceed 100% of the project's Fair Market Value
1262 (FMV) or Replacement Cost.
1263
1264 4. Non-mortgageable costs (i.e. replacement cost items, not eligible for inclusion in the
1265 FHA-insured loan) to be covered by governmental secondary loans, or grants lent to
1266 the property as a secondary loan, must be certified by the funding source to be
1267 reasonable and necessary to complete the project and that the project costs to be covered
1268 by the secondary financing are reasonable. Documentation to this effect must be
1269 included with the application submission.
1270
1271 5. The governmental secondary financing Lender must agree to and enter into a
1272 Subordination Agreement – Financing (HUD-92420-ORCF) that details the rights
1273 and legal relationship between the FHA-insured first mortgage and the secondary
1274 financing loan.
1275

B. When secondary financing ~~when~~ is from a private source:

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1278 1. **Section 232 New Construction, Substantial Rehabilitation & Blended Rate.**
1279 Secondary financing from a private source is not permitted.
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2. **Section 223(f).**

- a. The secondary financing must be evidenced by a promissory note conforming to the Surplus Cash Note (Form HUD-92223-ORCF). For Section 232 pursuant to 223(f) transactions involving Non-profit Borrowers use the Residual Receipts Note – Non Profit Mortgagor (Form HUD-91710-ORCF). This form must not be altered in any manner.
- b. The secondary financing is permitted to cover a portion of the equity requirement under Section 223(f). The aggregate amount of the FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. Therefore, the amount of a private loan may range from 7.5% of FMV (the difference between 85% and 92.5% of FMV) to a larger percentage if loan criteria lower than 85% of FMV controls. Secondary financing from private sources are not permitted under other Sections of the Act. However, this allowance must not be used to circumvent existing policies which do not permit equity take-out on Section 232 refinance transactions or on purchase transactions, a way to finance costs that otherwise would not be permitted. For example, seller take backs on property acquisition costs that are not supportable by market data must not be approved.
- c. When private secondary financing is combined with federal, state or local governmental agency secondary financing, the aggregate amount of FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. However the governmental loan, in aggregate with the FHA-insured first and private second, may exceed the property’s FMV. The addition of the governmental loan may result in total liens that exceed the property’s FMV.
- d. Private secondary financing may be used to cover non-mortgageable costs in combination with equity or solely for one purpose or the other. Whatever option is decided upon, the aggregate of the FHA-insured first and private second cannot exceed 92.5% of FMV.
- e. Non-mortgageable costs or non-HUD replacement cost items to be covered by secondary financing from private sources must be certified by the funding source to be reasonable and necessary to complete the project and that the project costs to be covered by the secondary financing are reasonable. Documentation to this effect must be included with the application submission.
- f. **Mezzanine Financing.** Mezzanine financing is provided by a private lending source and is usually secured by a pledge of partnership interests rather than by a secondary lien on the real estate. The existence and terms of all mezzanine debt must be fully disclosed to and approved by HUD during the application process. Any mezzanine debt that remains from a previous financing of the property is subject to the secondary financing guidance for private sources in this section. Repayment of mezzanine financing can only be made from surplus cash ~~and the mezzanine loan cannot mature before the term of the FHA insured loan.~~ It must be shown that the projected surplus cash may be reasonably expected to pay the interest due on the mezzanine loan. The mezzanine loan interest rate typically will be higher than the rate of the first mortgage, but must be reasonably consistent with market rates for mezzanine debt and must not be

1326 so high a rate that it jeopardizes the ownership stability of the property or that
1327 the interest due cannot reasonably be expected to be repaid from surplus cash.
1328 Interest due or accruing on the mezzanine loan must be approved as reasonable
1329 by ORCF.

1330
1331 Any transfer of an ownership interest in the borrower entity or in its principals
1332 to the mezzanine Lender in the event of nonpayment or a default on the
1333 mezzanine debt must have prior written approval by ORCF through the
1334 Transfer of Physical Assets (TPA) process or it will be invalid. The
1335 mezzanine Lender can exercise no enforcement remedies against the real
1336 estate or against the borrower entity during the term of the mezzanine loan.
1337

1338 **C. Repayment of Secondary Financing.** Repayment of public or private secondary financing,
1339 including interest, must be soft and be made solely from 75 percent of available surplus cash
1340 or residual receipts (Percentages other than 75% that are set forth in existing previously
1341 executed surplus cash notes shall continue to be honored) . ~~At The Borrower's principals~~
1342 may elect to make additional payments from nonproject fund~~option additional payments may~~
1343 ~~be made from non-project funds~~, however, these payments must not be pledged or scheduled
1344 for repayment.

1345
1346 **D. Promissory Notes.** The Borrower may secure a promissory note with a subordinate lien
1347 against the property under the following conditions:

- 1348
- 1349 1. The Lender on the insured mortgage must consent to the placing of the subordinate
1350 lien and agree that its existence does not constitute a basis for default on the first
1351 mortgage.
 - 1352
 - 1353 2. There must be a simultaneous closing and same day recordation of the subordinate
1354 financing documents and the first mortgage insurance documents.
 - 1355
 - 1356 3. The terms of the subordinate mortgage must be:
 - 1357 a. Approved by the HUD Counsel;
 - 1358 b. Consistent with the terms of the insured promissory note, the first mortgage,
1359 the Regulatory Agreement and all HUD Regulations and OHP Section 232
1360 Program Requirements.
 - 1361 c. The subordinate mortgage must not contain a cross default provision or any
1362 right of foreclosure before the termination of the FHA-insured mortgage.
 - 1363 d. The term of the subordinate mortgage must be extended, if:
 - 1364 i. The note matures, there are no surplus cash funds or residual receipts
1365 available for repayment and the first mortgage has not been repaid in
1366 full.
 - 1367 ii. HUD grants a deferment of amortization or forbearance that result in an
1368 extended maturity of the insured mortgage.
 - 1369 e. The subordinate mortgage must be assumable when a sale or transfer of
1370 physical assets occurs and the insured mortgage remains in place.

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- i. The holder of the subordinate mortgage cannot require that more than 75 percent of the net proceeds of the sale or transfer be applied to the reduction of the loan.
 - ii. For these instructions, net proceeds are the funds available to the original Borrower after correcting any monetary or covenant default on the first mortgage, making:
 - 1. Required contributions to any reserve fund, and
 - 2. Needed improvements to the property as evidenced by HUD's annual inspection reports.
 - f. The subordinate mortgage must automatically terminate if HUD acquires title to the project by a deed in lieu of foreclosure.
 - g. Only 75 percent of surplus cash can be pledged to the repayment of the subordinate loan(s).
- E. **Accounts Receivable (AR) Financing.** AR financing is permitted provided that all of the requirements in Production, Chapter 15 are met, and ORCF has approved the terms of the AR financing.