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Greater Oversight Needed of FHA's Nursing Home Insurance Program

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Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Jim Leach
Chairman
The Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking and
Financial Services
House of Representatives

The Department of Housing and Urban Development (HUD), through two Federal Housing Administration (FHA) programs, has insured private lenders against financial losses from borrowers' defaults on mortgages for nursing homes and retirement service centers. The nursing home program, established in 1959, was expanded recently to include insurance coverage for assisted living facilities, a type of residential care facility for the elderly and disabled. The retirement service center program, terminated in 1991 after 8 years of operation primarily because of many loan defaults, was also targeted to the elderly population. The loans for these programs are part of FHA's multifamily loan portfolio.

This report was prepared to comply with the requirements in the Multifamily Housing Property Disposition Reform Act of 1994 (P.L. 103-233, Apr. 11, 1994) that we report on the nursing home, retirement service center, and hospital insurance programs in FHA's multifamily loan portfolio.[1] As agreed with your offices, we evaluated (1) the relationship of the nursing home and retirement service center insurance programs to FHA's mission, (2) information on the programs' financial performance and HUD's estimates of potential future losses under these programs, and (3) HUD's ability to manage these programs.

[1]The results of our study on the hospital insurance program will be provided in a separate report.

Results in Brief

HUD officials, including the Deputy Assistant Secretary for Multifamily Housing Programs, believe that the nursing home program supports HUD's mission by serving populations or areas that are not adequately served by the private sector, such as rural communities. However, the extent to which FHA's nursing home program has achieved these objectives is uncertain. The nursing home program has not been targeted to serve specific populations or communities, and HUD does not collect and analyze information on whom the program is serving. When HUD evaluated the market being served by the retirement service center program, it found that the private sector and the FHA program were primarily serving the same market.

FHA has not done any complete assessments of the financial performance of the nursing home and retirement service center programs. Furthermore, because, historically, HUD's data systems have not tracked the receipts and expenditures for its individual mortgage insurance programs, the actual financial performance of these programs can only be estimated. HUD's data that may be used to approximate the financial performance of the nursing home program during its 35-year history indicate that losses of approximately $187 million, adjusted for inflation, have been incurred. Additionally, FHA's fiscal year 1994 loan loss reserves anticipate future losses equivalent to about 19 percent of the $3.7 billion balance of nursing home loans in the portfolio as of September 30, 1994. While fewer cost data are available for the retirement service center program, it is clear that the program has incurred losses. For example, HUD's data show that about 46 percent of the retirement service center program's total portfolio of about $1.4 billion had defaulted and resulted in FHA insurance claims as of September 30, 1994.

We believe it is unlikely that HUD will be able to effectively manage the nursing home and retirement service center programs in the near future. For example, many of HUD's current efforts to overcome the staffing inadequacies, data deficiencies, and poor management controls that have hindered its portfolio management capability for many years are in the early stages. In addition, while HUD is planning to consolidate its multifamily underwriting and asset management responsibilities in response to the Department's proposed restructuring and downsizing, it is not clear when the consolidations—and the potential benefits of loan specialization that this restructuring offers—will be implemented departmentwide. In the meantime, HUD has implemented legislative changes that authorize FHA mortgage insurance for assisted living facilities which may result in the nursing home program's growth and in potentially

riskier loans especially if FHA is unable to effectively underwrite insurance for the loans and monitor their performance.

Background

Section 232 of the National Housing Act, as amended, authorizes FHA to insure mortgages made by private lenders to finance the construction or renovation of skilled nursing facilities, intermediate care facilities, board and care homes, and assisted living facilities, as well as combinations of these types of projects.[2] As of September 30, 1994, the insured nursing home portfolio consisted of about 869 loans with an aggregate unpaid principal balance of $3.7 billion.

In 1994, HUD issued regulations implementing legislation that has expanded FHA's nursing home program to include mortgage insurance for the refinancing of non-FHA-insured projects and for assisted living facilities. HUD had previously revised its regulations to allow for the refinancing of FHA-insured projects. Assisted living facilities offer a combination of housing and personalized health care, including separate living units for residents, common areas, and assistance with activities of daily living, such as bathing, dressing, and eating. According to HUD's Director of Insured Multifamily Housing Development, assisted living facilities under the nursing home program will generally be unsubsidized, market-rate projects serving the moderate- and upper-income elderly.

FHA's terminated retirement service center program also served the upper-income elderly, providing unsubsidized rental housing that had more services and amenities, such as meals, than those available in the typical FHA-insured project for the elderly.[3] HUD established this program administratively under section 221(d)(4) of the National Housing Act, which provides for multifamily rental housing for moderate-income families. The retirement service center program was not part of the nursing home program. Because retirement service center loans are included with other market-rate housing loans, HUD's data systems cannot readily identify retirement service center projects. According to HUD's July 12, 1995, report on retirement service centers, 85 retirement service

[2]These facilities form a "continuum" offering varying degrees of care. For ease of presentation, we refer to any mortgage insured under section 232 as a nursing home loan and to FHA's section 232 program as the nursing home program. About 89 percent of the unpaid principal balance of insured loans is under the basic section 232 program, which provides coverage for new construction and substantial rehabilitation of these facilities. The remaining loans include supplemental loans and refinancing. (See app. I for a description of section 232 facilities and loans.)

[3]When a loan insurance program is terminated, new loans are not added to the portfolio. However, existing loans remain in force until they are either paid in full or default.

center loans with original face amounts of $689 million were in force as of September 30, 1994.[4]

When a default occurs on an insured loan, a lender may assign the mortgage to HUD and receive payment from HUD for an insurance claim. Each year, FHA establishes loan loss reserves to reflect the net amount that the agency expects its insurance funds to lose from future defaults on loans in the existing multifamily portfolio.[5] FHA is also required each year, under the Credit Reform Act of 1990, to estimate credit subsidies—the net costs to the government of insuring new mortgages. The act requires that for credit instruments—including mortgage insurance—budget authority be provided for credit subsidies to cover the government's cost before such credit is extended. The federal budget shows whether credit programs lose money, break even, or make a "profit."[6]

Furtherance of HUD's Mission by Programs Is Uncertain

As an agency of HUD, FHA is to further the Department's overall mission of enhancing opportunities for housing and community development. HUD officials, including the Deputy Assistant Secretary for Multifamily Housing Programs, believe the nursing home program supports HUD's mission by serving populations or areas that are not adequately served by the private sector. However, the extent to which FHA's nursing home program has achieved these objectives is uncertain. The nursing home program has not been targeted to serve specific populations or communities, and HUD does not collect and analyze information on whom the program is serving. When HUD evaluated the market being served by the retirement service center program, it found that the private sector and the FHA program were primarily serving the same market—the upper-income elderly.

Extent to Which the Nursing Home Program Furthers HUD's Mission Is Unclear

The mortgage insurance program for nursing homes was established by the Congress in 1959 to encourage the construction of nursing homes. At that time, the Congress believed that sponsors of for-profit nursing homes had difficulty in obtaining financing on reasonable terms.[7] According to

[4]We did not evaluate the reliability of the data contained in the report Retirement Service Centers, by Richard G. Calvert, Thomas N. Herzog, James E. Laverty, Darrel S. Connelly, Statistical and Actuarial Analysis Staff, HUD (July 12, 1995). On August 2, 1995, HUD reported that it is revising the report to reflect new data.

[5]Our report HUD Management: FHA's Multifamily Loan Loss Reserves and Default Prevention Efforts (GAO/RCED/AIMD-95-100, June 5, 1995) identified limitations that reduced the reliability of FHA's estimate of fiscal year 1993 loss reserves.

[6]These calculations are made before administrative costs are taken into account.

[7]The program was expanded in 1964 to provide coverage for nonprofit sponsors.

officials in the Policies and Procedures Division of HUD's Insured Multifamily Housing Development Office, lenders generally viewed nursing homes as risky ventures prior to the establishment of the Medicaid reimbursement program in 1965. The nursing home program was intended to overcome private lenders' reluctance to finance nursing homes by drawing on FHA's experience in credit enhancement programs to minimize the lenders' risk of financial losses. The passage of the Medicaid program in 1965 provided a more reliable income stream for nursing homes by reimbursing their costs.

Since the program's inception, FHA has insured over 2,000 nursing home loans totaling about $5.1 billion. By comparison, over 16,000 skilled nursing and intermediate care facilities were in the United States as of March 1994. In addition, the American Association of Retired Persons (AARP) reports that an estimated 32,000 licensed board and care homes are in the United States, some of which are assisted living facilities. Because assisted living facilities can be called by a variety of names, the exact number is difficult to determine; however, the Assisted Living Facilities Association of America represents about 12,000 facilities.[8] These statistics indicate that a relatively small number of nursing homes operating in the United States today were financed with mortgage loans carrying FHA insurance. Nonetheless, the Deputy Assistant Secretary for Multifamily Housing Programs and officials in HUD's Insured Multifamily Housing Development Office and in the Housing Management Divisions of two of the three field offices we visited believe that the nursing home program furthers HUD's broad mission of increasing opportunities for housing and community development.

Specifically, HUD officials said that the program supports HUD's mission by insuring mortgages for nursing homes that may serve populations such as low-income individuals or areas such as small rural communities or inner cities that are not adequately served by the private sector. In addition, HUD officials said the program also supports the Department's mission by assisting borrowers who might otherwise be unable to obtain financing for nursing homes. Along these lines, a 1993 report indicates that nonprofit, public, and small for-profit entities are most likely to obtain financing from either the FHA or state programs, whereas large for-profit entities generally

[8]Data on skilled nursing and intermediate care facilities were reported as of March 1994 by the Department of Health and Human Services. Statistics on board and care homes and assisted living facilities were cited in February 1995 by AARP.

obtain financing from commercial banks, savings and loan associations, and life insurance companies and through the stock market.[9]

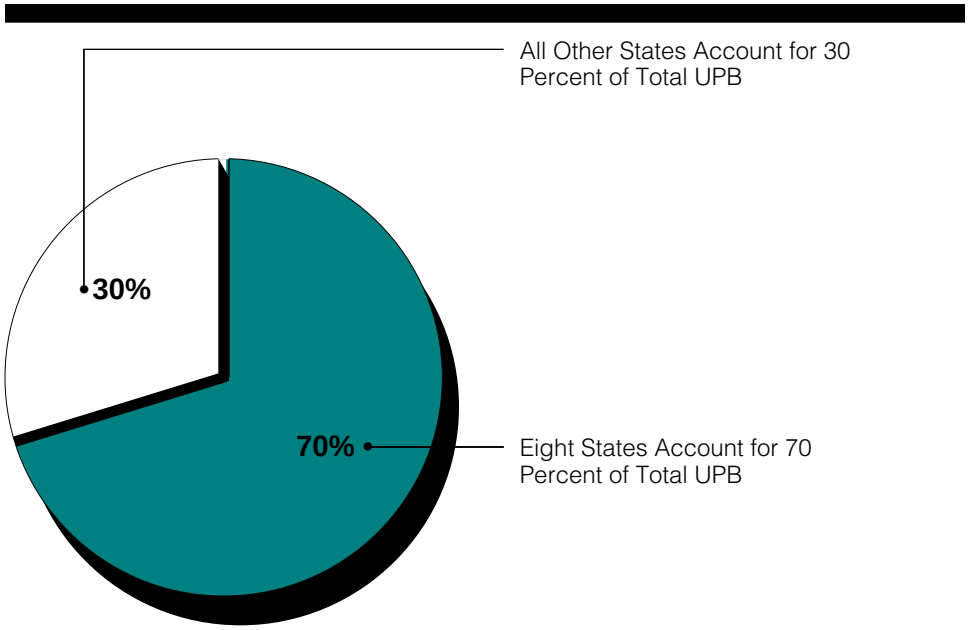
Nonetheless, the extent to which the program actually achieves the purposes cited by the HUD officials is uncertain. For example, the nursing home program is not targeted to specific unmet market needs, such as providing access to nursing homes to underserved locations and populations, nor are borrowers required to demonstrate that they could not obtain financing without FHA mortgage insurance. Current FHA borrowers that we contacted cited various reasons why they used FHA insurance in financing their nursing homes. While some noted the unavailability of other financing, others cited different reasons; for example, the program enabled them to obtain lower interest rates and the program offers "nonrecourse" terms, which protect investors. While FHA does have requirements to determine whether sufficient market demand exists for nursing home projects that it insures, the requirements are not specifically aimed at determining whether a project will meet a need that would not otherwise be met by the private sector.[10] Furthermore, HUD does not collect and analyze information on whom the program is serving, such as the income levels of the patients served by FHA nursing homes, the economic characteristics of the communities in which FHA nursing homes are built, or the borrowers' ability to obtain financing without FHA insurance.

Available information indicates that participation in FHA's nursing home program varies widely by state. About 32 percent of FHA's nursing home loan balances cover facilities located in New York, and another 38 percent of FHA's nursing home loan balances cover facilities located in seven other states. (See fig. 1.) In contrast, FHA currently insures only a small number of nursing homes in many states. For example, FHA currently insures 2 percent of the nursing homes in California and 1 percent of the nursing homes in Texas. (See app. II.)

[9]See Financing Options for Long Term Care Facilities in the United States, Institute for Health and Aging, University of California (Sept. 1993). The report, funded in part by HUD, presents data from a small 1993 telephone survey on current public and private financing options for nursing homes and board and care facilities.

[10]Most states use a certificate-of-need process that limits the number of new nursing homes to those for which the state certifies that a sufficient market demand exists. HUD requires a certificate of need for the states that use this process. Alternatively, HUD requires a market analysis demonstrating adequate demographic demand and financial viability for these states.

Figure 1: Geographic Distribution of $3.7 Billion Total Unpaid Principal Balance in FHA's Insured Nursing Home Portfolio, as of September 30, 1994



Eight states each have over $150 million in UPB. New York has $1.2 billion in UPB, which is 32 percent of the total. Massachusetts, Ohio, Virginia, New Jersey, Illinois, Rhode Island, and Pennsylvania together account for 38 percent of the total.

Legend

UPB = Unpaid principal balance

The Retirement Service Center Program and the Private Sector Served the Same Market

The retirement service center program did not contribute to HUD's mission of serving unserved markets. When HUD terminated the retirement service center program in 1991, it reported that the program primarily assisted the upper-income elderly and that the private sector also had been developing a wide variety of similar products for the upper-income elderly.

HUD established this program administratively in 1983 with the urging of developers to provide market-rate rental housing for the elderly with a significant level of services and amenities over and above those found in the typical HUD-insured project for the elderly. However, as the HUD Inspector General has noted, HUD implemented the program without having fully assessed the risks and benefits of the Department's

involvement in underwriting loans for retirement service centers.[11] In particular, HUD did not do an adequate job of analyzing the market for such housing—an error that was also made by some private sector investors in retirement centers in the 1980s who also incurred losses as a result of defaults.

For example, HUD underestimated the reluctance of many seniors to move from their current home to alternative housing. In addition, because retirement service centers had no direct federal rental subsidies, the high rents associated with these projects made them affordable to only the upper-middle-income to upper-income elderly population. As a result of these and other factors, the program incurred a high level of loan defaults.

Because of the defaults, the Secretary placed a moratorium on insuring additional facilities in 1989. HUD terminated the program in 1991, at which time, it reported that approximately 53 percent of the retirement service center projects had either defaulted or were experiencing financial or operational difficulties. In terminating the program, HUD noted that this action would not cause a gap in the types of housing and support services available to serve the lower-income elderly because retirement service centers charged market rate rents and had no direct federal rental subsidies.

Financial Data and HUD's Analyses Indicate Losses for Programs

Because of data limitations, the financial performance of the nursing home and retirement service center programs can only be estimated. Cost estimates for both programs indicate that they have incurred losses. HUD's data also indicate that both programs will experience a significant number of loan defaults in the future. Furthermore, HUD's credit subsidy estimates for the nursing home program, which assume that receipts will exceed costs, may be unreliable.

Both Programs Appear to Have Incurred Losses to Date

HUD has not done any complete assessments of the financial performance of the nursing home and retirement service center programs. For example, "actuarial" studies conducted periodically on these programs focus primarily on the number of defaults and the original loan balances associated with the defaults but do not analyze the full costs of the programs. Therefore, this information does not establish whether the

[11]Multi-Region Audit of the Insured Retirement Service Centers Program, Office of the Inspector General, HUD, 90-TS-111/112-0008 (Apr. 6, 1990).

programs operate at a profit or a loss.[12] Furthermore, while HUD's data systems currently track receipts and expenditure data associated with its individual mortgage insurance programs, cumulative receipts and expenditure data for its insurance programs are not available because historically the data systems have not tracked these data for the Department's individual programs.[13] Consequently, the actual financial performance of the nursing home and retirement service center programs can only be estimated.

Data from HUD that may be used to approximate the financial performance of the nursing home program from its inception to September 30, 1994, indicate that losses were likely incurred under this program. Specifically, HUD's data on loan defaults, original loan amounts, premium payment requirements, and recoveries from the sale of notes and properties indicate that the nursing home program has incurred losses of approximately $187 million, adjusted for inflation, since its inception.[14] Primarily because of the data limitations, we excluded some expenses, such as administrative costs, and developed some assumptions, for example, on recovery amounts from the sale of defaulted notes or properties, which tend to understate the cost of the nursing home program. These factors are discussed in more detail in appendix III, which summarizes our methodology for estimating the losses of the nursing home program.

Available data indicate that the terminated retirement service center program has incurred losses as well. For example, in terminating the program in 1991, HUD estimated that net losses to the insurance fund could total about $300 million. Furthermore, HUD's data show that about 46 percent of the total retirement service center portfolio of about $1.4 billion had defaulted as of September 30, 1994.[15] While HUD has not updated its net loss estimates, HUD's data indicate that claims have been paid on loans with an original face value of $648 million.

[12]Profits or losses represent the difference between the present value of program receipts (such as premium income collected and sales receipts) and expenditures (such as claims paid and selling expenses).

[13]In addition, according to HUD accounting officials, files on defaulted loans were not retained for more than 10 years. The enhancements to the data systems supporting program-by-program data were phased in from about 1987 through 1992.

[14]This amount represents the sum of the program's estimated cash flows under the basic section 232 program, excluding administrative costs, from 1959 to 1994, adjusted to 1994 dollars. The estimated loss in nominal dollars is $70 million. The estimate does not include the interest cost of federal debt associated with the program or the interest income that HUD received on some of its assigned loans, which partially offset the federal interest cost.

[15]See footnote 4.

Indicators of Future Performance Project Continuing Defaults

As part of the analysis of the fiscal year 1994 loan loss reserves for its insured multifamily inventory, FHA developed an estimate of future losses expected from defaults on loans insured under the nursing home program. On a net present value basis, FHA estimated that it will sustain approximately $724 million in future losses from loan defaults. This amount includes an offset representing estimated premium receipts for loans evaluated in the analysis as having a low risk of default. The loss reserves represent about 19 percent of the total unpaid principal balance of nursing home loans insured as of September 30, 1994.

FHA's loan loss reserve estimates are based primarily on analyses of the financial and physical condition of properties with FHA mortgage insurance. They do not specifically consider the potential financial impacts of changes in health care policies on nursing homes. Although the exact nature of future national changes in health care is uncertain at the present time, the health care industry is currently undergoing significant changes as a result of national and state efforts to contain costs and reform the health care system. Industry and government officials with whom we spoke generally do not believe that proposed and ongoing changes in the health care industry will have a negative impact upon FHA's nursing homes. However, efforts by federal, state, and local governments to control rising health care costs—such as current state and federal actions to reduce Medicaid and Medicare costs—could increase risks and undermine the financial viability of some of these projects. For example, a substantial portion of nursing homes' revenue is provided from Medicaid reimbursements.[16] (See app. IV.)

In addition to the high number of defaults of retirement service center loans that have occurred to date, more defaults are expected. We conducted a survey of HUD's loan servicers in November 1994 to determine the extent to which they believed the remaining retirement service center loans were likely to default in the future.[17] (See app. V for the scope and methodology for the survey.) The results of this survey and the recent financial analysis of most of the remaining retirement service center loans by a HUD contractor indicate that additional loan defaults under the program are likely. HUD's loan servicers indicated that about 18 percent of

[16]Medicare is a health insurance program administered by the Health Care Financing Administration for persons aged 65 or older and for disabled persons who are eligible for care. Medicaid is a joint federal-state program under which the states assume primary administrative responsibility for health care coverage for the aged, disabled, and economically disadvantaged.

[17]HUD's loan loss reserve analysis does not analyze retirement service center loans separately, and the small number of these loans in the loss reserve sample did not provide sufficient data to reliably estimate the level of future defaults in this program.

the remaining retirement service center loans that we identified were likely to default in the future. The unpaid principal balance for these projects was approximately $192 million as of September 30, 1993.

Furthermore, an analysis of the 1993 audited financial statements of 90 retirement service center projects, conducted in 1994 for HUD by a contractor, rated one-half of these projects as "poor" in at least two of the five financial ratios evaluated. In nine of these cases, the auditors' opinions raised a "going concern issue," indicating that the auditors seriously question the continued viability of these projects. The unpaid principal balance for the projects with two or more poor ratings was $392 million.

Credit Subsidy Estimates May Not Accurately Reflect Future Losses

HUD's credit subsidy estimates for nursing home loans to be endorsed in fiscal year 1996 may not accurately reflect the losses that are likely to be incurred as a result of future defaults on such loans. HUD's fiscal year 1996 credit subsidy estimate for the nursing home program projects a profit—that is, HUD expects that the net present value of receipts on these loans (insurance premiums and recoveries on loan defaults) will exceed losses resulting from default claims. For several reasons, we believe that this estimate may not be reliable. First, according to HUD budget staff, the credit subsidy calculation was based on assumptions about loan performance contained in a 1992 report by Price Waterhouse that HUD applied to a standard credit subsidy model (spreadsheet) used by the Office of Management and Budget. According to the HUD staff, the data used to provide the credit subsidy estimates have not been updated even though the most recent data used in the Price Waterhouse study are from 1990. Furthermore, according to the study, because of the lack of available financial data on nursing home loans, the models used in the study were based on historical trends and economic indicators and did not incorporate project-specific financial indicators. The study noted that the general economic models used in the study cannot explain loan performance as accurately as loan-specific models.

Second, HUD's fiscal year 1996 credit subsidy estimate assumes a higher recovery rate on defaulted loans than HUD has historically experienced—60 percent as opposed to the 40.2-percent rate supported by HUD's data.[18] Third, HUD's credit subsidy estimate does not take into account the differences in default risk that may result from HUD's

[18]We estimate HUD's recovery rate for the nursing home program to be about 40.2 percent. (See app. III.)

insurance of assisted living facilities compared with its insurance of nursing homes. These differences are discussed in the next section of our report. And last, a recent study prepared for the Mortgage Bankers Association indicates that the nursing home program has incurred losses in the last 8 years and requires a small credit subsidy. That study also used the 60-percent recovery rate that HUD uses in its credit subsidy model, which may underestimate the program's losses.

Program and Agency Changes May Further Strain FHA's Management Capacity

As discussed in our June 1995 report on FHA's loan loss reserves and default prevention efforts, HUD is unable to provide adequate oversight and management of its existing multifamily loan inventory, including nursing home and retirement service center loans.[19] While HUD is taking steps to overcome its historical loan management deficiencies, its ability to improve its management may be negatively affected, at least in the short run, by the planned FHA restructuring and staff reductions. Currently, HUD's loan servicers provide limited oversight of nursing home and retirement service center loans. Moreover, recent legislative changes may result in the growth of the nursing home program and potentially riskier loans, placing additional strains on HUD's management capacity.

HUD's Multifamily Loan Portfolio Not Adequately Managed

Numerous studies over the past 2 decades by Price Waterhouse, HUD's Office of Inspector General, and us have identified weaknesses in FHA's ability to effectively manage its multifamily portfolio, which includes the nursing home and retirement service center programs. The agency currently insures a number of multifamily properties that are in poor condition and projected losses of $9.5 billion from future defaults of loans in its $45.4 billion insured multifamily portfolio as of September 30, 1994. Although HUD is taking steps to overcome staffing inadequacies, data deficiencies, and poor management controls that have hindered its ability to manage the portfolio for many years, many of the Department's efforts to improve its management are in the early stages. Some of the corrective actions could take years to accomplish. For example, efforts to overcome the serious data deficiencies in FHA's multifamily portfolio are only at the strategic planning stage. As such, HUD continues to have only limited ability to oversee these programs, and we cannot determine at this time whether HUD's initiatives will be successful.

In addition, HUD is proposing organizational changes and staffing cuts that could, at least in the short run, place additional strains on FHA's portfolio

[19]GAO/RCED/AIMD-95-100 (June 5, 1995).

management. In December 1994, HUD issued its "Reinvention Blueprint" proposing broad departmental changes, including restructuring FHA, in an effort to operate more efficiently and effectively.[20] HUD's fiscal year 1996 budget proposal would streamline HUD's headquarters and field office operations, reducing staff from the current level of 12,000 to about 7,500 over the next 5 years. Under HUD's proposal, FHA would be transformed into a "streamlined, business-oriented government entity." As a new "market-driven corporation," FHA would consolidate its many existing insurance programs into three broad authorities: single-family homeownership; multifamily rental housing; and health care facilities. These sweeping proposals are likely to change the nature and extent of FHA's future involvement in managing the multifamily portfolio.

According to the Deputy Assistant Secretary for Multifamily Housing Programs, HUD is studying ways to consolidate its multifamily underwriting and asset management responsibilities in response to the proposed departmental restructuring and downsizing. For example, HUD is planning to assign loan originations for assisted living facility loans for its Region 10 offices in Alaska, Idaho, Oregon, and Washington State to the Seattle, Washington, field office to bring efficiency and specialization to the loan origination process for nursing home loans that are unlike other multifamily loans. The Deputy Assistant Secretary said that concentrating highly experienced staff in a few locations will reduce the risk associated with certain types of loans, such as those of assisted living, board and care, and intermediate care facilities. In addition, the Deputy Assistant Secretary indicated that HUD is currently redesigning its program for nursing homes and other residential health care facilities. The Department is considering changing fees and premiums as well as basic underwriting terms, such as reductions in loan-to-value limits and shorter mortgage terms.

Program's Expansion May Further Strain HUD's Oversight Ability

The recent expansion of the nursing home program to include mortgage insurance for assisted living facilities (as well as for refinanced loans covering non-FHA-insured nursing homes) could strain HUD's already limited capacity to manage nursing home and other multifamily loans. Our work in several HUD field offices, as well as data from FHA's loan loss reserve analysis, indicates that HUD's loan servicers provide limited oversight of nursing home and retirement service center loans. For example, of the 142 nursing home loans that HUD sampled in its fiscal year

[20]In May 1995, HUD issued the American Community Partnerships Act, a legislative plan to implement the blueprint's proposals.

1994 loan loss reserve analysis, only 36 had received recent management reviews and 87 had current physical inspections. In general, HUD's loan management staff that we contacted viewed nursing home loans as low-risk and, as a result, generally do not focus attention on nursing home loans unless financial trouble appears imminent or a default occurs.[21]

The new assisted living component of the nursing home program has the potential to further strain HUD's management capabilities.[22] This additional strain could result not only from the fact that the program could increase the size of FHA's insured loan portfolio but also because the default risk associated with insuring assisted living facilities could be higher than that for other nursing home loans—particularly if the new program is not effectively managed. In this regard, assisted living facilities differ from nursing homes in fundamental ways that can potentially increase the risk of default. For example, while most states limit the supply of skilled nursing homes through the certificate-of-need process, similar limits are not placed by most states on assisted living facilities. Furthermore, the new assisted living facilities program shares some characteristics with the failed retirement service center program in that both target the moderate- and upper-income elderly. As such, these projects typically do not receive Medicaid financing and require careful analysis to ensure that sufficient market demand exists to support the facilities.

Officials in HUD's Insured Multifamily Housing Development Office believe that several differences between assisted living facilities and retirement service centers will mitigate the risks associated with their similarities. For instance, unlike retirement service centers, FHA's assisted living facilities (1) will be licensed and regulated by the states; (2) are expected by FHA to be developed and managed by developers and operators experienced in the delivery of long-term care, although no specific level of experience is required; and (3) are intended for residents who, by virtue of their physical condition, no longer have the option of living independently, resulting in a more need-driven market for these facilities. However, as noted earlier, state monitoring and regulation, which focus on the adequacy of health care, do not address default prevention. Furthermore, the extent to which experienced developers and adequate market analysis

[21]One reason cited by field staff for believing that nursing home loans are low-risk is that these facilities are monitored and regulated by the states. However, some field staff and an industry expert, as well as a report by HUD's Inspector General, indicate that state monitoring focuses on the adequacy of care given to patients and not on the financial viability of nursing home operations.

[22]HUD's regulations authorizing FHA insurance for assisted living facilities became effective on December 29, 1994.

are used in this program will depend on the HUD field staff responsible for analyzing and underwriting the insurance.

HUD's Director of Insured Multifamily Housing Development acknowledged that excessive workloads could limit HUD's ability to adequately administer the assisted living program. However, she stated that HUD will attempt to minimize the risks of assisted living projects through careful underwriting evolving, in part, from HUD's plans to provide special training to field staff. Training is critical because, as HUD has recognized, the lack of extensive training in underwriting projects exacerbated the problems that HUD experienced with the failed retirement service center program. Nonetheless, HUD's plans to have initial training completed in early 1995 were not implemented. However, HUD did provide training for underwriting assisted living facility loans to its field offices via a live broadcast from headquarters on August 16, 1995. In addition, HUD plans advanced valuation training for staff from several field offices in August 1995. The training will emphasize market and marketability issues for nursing homes and board and care and assisted living facilities.

HUD's ability to effectively oversee the assisted living program may be further constrained, in our view, by the fact that the Department has not conducted a market feasibility study to fully assess the risks and benefits associated with assisted living facilities. According to HUD officials, the Department's policy is to perform feasibility studies only for new programs. Because HUD views the assisted living program as an expansion of FHA's nursing home program rather than a new program, it does not believe that the assisted living program warrants a feasibility study. However, as noted earlier, the lack of a full assessment of the risks and benefits in underwriting retirement service center loans was cited by HUD's Inspector General as contributing to the problems associated with that program.

Officials in HUD's Insured Multifamily Housing Development Office and field offices also believe that FHA's experience with board and care projects will help ensure effective management of the loans for the assisted living program. However, according to available data, board and care projects are a small part of the nursing home portfolio, and many of HUD's field offices have little or no experience with board and care facilities.[23]

[23]HUD's data systems do not identify board and care facilities in the insured nursing home portfolio, so the actual number included is not known. Several listings provided by HUD indicate that board and care facilities may constitute about 15 percent of the nursing home portfolio.

In addition, in response to our questions about the default risk of board and care facilities, HUD conducted a preliminary analysis of nursing home default claims since 1986 that indicates that FHA may need to strengthen its underwriting standards for board and care facilities. According to the Deputy Director of the Office of Insured Multifamily Housing Development, the preliminary results indicate that a higher proportion of loans for board and care facilities have defaulted than these facilities' relative share of the nursing home business. HUD is currently taking steps to begin tracking loans for board and care and assisted living facilities in its data systems, but these efforts have not been fully implemented. Furthermore, the steps that HUD plans to take to monitor the performance of these loans after it starts to track them remain unclear.

Conclusions

HUD has not collected and analyzed information needed for it to effectively manage the nursing home program and for it to assess whether the program's benefits outweigh its costs. While HUD officials believe that the nursing home program serves populations and geographic areas that are not adequately served by the private sector, the Department has not analyzed the types of communities and individuals that the program actually serves nor has it systematically collected the information needed to perform such an analysis. As a result, the extent to which FHA's nursing home program has contributed to HUD's mission is uncertain. In addition, HUD has not performed complete assessments of the nursing home program's financial performance, although in recent years more complete financial data on the program have been collected. In our view, analyses of whom the program is serving and the costs associated with providing such service are essential elements of managing the program.

FHA's loan loss reserve estimates and its credit subsidy estimates are intended to reflect, respectively, the potential losses associated with loans in its insured multifamily portfolio as well as loans that FHA plans to insure in the coming fiscal year. However, neither of these estimates, in our view, currently provides a complete assessment of the likelihood of such losses. While FHA has made improvements in its loan loss reserve estimates, estimates of losses related to expected nursing home loan defaults, based on assessments of the nursing homes' physical and financial condition, do not take into account how changes in health care financing may affect the default potential of these loans. In addition, FHA's credit subsidy estimates for nursing home loans are based on outdated and questionable data and do not reflect the differences in the default risk of loans insured in the past and those that will be insured in the future.

In our view, HUD has not been able to provide adequate oversight of loans in its insured multifamily portfolio, including loans for nursing homes and retirement service centers. The addition of assisted living facilities to FHA's nursing home program could place additional strains on HUD at a time when its ability to effectively manage its existing multifamily portfolio is already limited. Furthermore, we are concerned about the potential risk associated with the addition of these loans to FHA's portfolio, especially since it is unclear how HUD will monitor the loans' performance.

Recommendations

To better measure the outcomes of FHA's nursing home program, we recommend that the Secretary of HUD direct the Deputy Assistant Secretary for Multifamily Housing Programs to (1) collect data on the characteristics of patients, locations, and borrowers for all future projects; (2) use the receipts and expenses data now tracked by HUD's data systems to monitor the program's financial performance; (3) reformulate credit subsidy estimates for nursing home loans on the basis of data that are up-to-date, are accurate, and, to the extent possible, take into account differences between the potential default risk of loans that are to be insured and loans that have been insured in the past; and (4) establish procedures to carefully monitor the financial performance of assisted living facility loans in the nursing home portfolio in a timely manner so that prompt action may be taken to prevent future loan defaults.

Matters for Congressional Consideration

Given the changes in health care and mortgage financing that have occurred since the nursing home program was established in 1959, the program's financial performance, HUD's limited management capabilities, and the Department's impending reorganization, the Congress may wish to review FHA's role in insuring loans for nursing homes and assisted living facilities. Among the issues that the Congress may wish to consider are (1) whether the program should be targeted more toward meeting specific needs or serving specific populations, (2) how the resource and management problems that have inhibited effective oversight of the program can be addressed, (3) what impact changes in the financing of Medicaid are likely to have on the default risk associated with FHA's nursing home portfolio, and (4) whether HUD has the capabilities to effectively underwrite the insurance for and oversee loans for assisted living facilities.

Agency Comments and Our Evaluation

We provided a draft of this report to HUD for comment. Appendix VI contains the complete text of HUD's comments, which were provided by the Deputy Assistant Secretary for Multifamily Housing Programs. HUD's comments did not include any substantive disagreements with the facts presented in the report. However, as discussed below, HUD disagreed with the scope of our report and one of our recommendations. HUD also cited actions it was taking to address the other recommendations and provided comments on a number of issues covered in the report.

HUD characterized the scope of the draft report as misleading because it did not, in the Department's view, appropriately distinguish between the operations or status of the nursing home and retirement service center programs. HUD stated that the programs are different products serving different markets and argued that we should issue separate reports on these two programs. However, throughout the report, we provide information on each program separately. We believe the report clearly distinguishes between the operations and status of HUD's nursing home and retirement service center programs. While there are clearly differences between the two programs, there are also similarities and instances in which the operation of one program has implications for the other. In addition, many in the housing and medical facility fields see housing and care for the elderly as a "continuum of care." The continuum starts with facilities that provide the lowest levels of assistance, such as retirement service centers; moves toward increased levels of care provided by board and care and assisted living facilities; moves to the various levels of nursing home facilities; and finally ends with hospital care. For these reasons, we believe it is appropriate to discuss both programs in a single report.

HUD disagreed with our recommendation that the Department collect data on the characteristics of patients, locations, and borrowers for future nursing home projects. The Department suggested additional language to the recommendation to state that the recommendation's purpose is to ensure that the Department serves the target population and then stated that nothing in the legislation directs the Department to target certain areas or populations. However, our recommendation is directed at HUD's obtaining a better measure of the outcomes of the program—that is, to have information on whom the program is serving. We believe this information is important for assessing the costs and benefits of the program. In addition, the Department maintained that a major effort at this time to collect such data is overly burdensome. To avoid an undue burden on the Department, our recommendation is prospective in nature.

Accordingly, we do not agree that collecting some additional data on new loans would be unnecessarily burdensome.

HUD also noted actions that it is taking as part of a strategic plan prepared in November 1994 that it believes will address our recommendations. While these actions appear worthwhile, they do not, in our view, affect the validity of our recommendations. For example, HUD states that its credit subsidy estimates are a subject of continuing discussion with the Office of Management and Budget and that as better data are obtained and more experience is gained, credit subsidy estimates will be refined and revised. However, HUD's comments are unclear about what specific improvements it expects to make in its credit subsidy estimates for the nursing home program and when those improvements will be made. Similarly, HUD states that its strategic plan includes other actions such as redesigning products to ensure a self-sustaining FHA, monitoring the financial performance of FHA programs, and implementing a variety of remedial actions on the basis of lessons learned from past practices. However, it is unclear what all of these actions will involve and how soon some of them will be completed.

HUD also provided comments on other issues in the report. For example, HUD pointed out that (1) the retirement service centers are "demand-driven" because they appeal to a relatively independent and well-off segment of the elderly population that has other options, including staying in their own home, and (2) assisted living facilities and board and care facilities are "need-driven" because they address situations in which the elderly can no longer remain fully independent and need the support and health-related services. Our report reflects these differences. Nonetheless, we note that this distinction does not guarantee a market for these facilities. For example, affordability and location are also likely to be important factors. Private sector experts with whom we spoke indicated that identifying the market for assisted living facilities is a difficult and complex task.

HUD asserted that the nursing home program serves those not served by the private sector. However, HUD acknowledged that it does not have data to substantiate its position. In our view, without such data, it is not clear to what extent FHA-insured facilities serve a need that would not otherwise be met by the private sector.

In our report, we provide information on the number of nursing homes in each state compared with the number of nursing homes currently in FHA's loan portfolio to show that participation in FHA's nursing home program

varies widely by state. HUD stated that FHA's share of the market should be computed by comparing what has happened in the market over the last few years. We noted in the draft report that the data presented provide an approximate representation of FHA's role in providing nursing homes in each state, and we identified the limitations in the data provided. In response to the Department's comment, we have further clarified that the information we provide is not sufficient to represent a complete analysis of FHA's share of the nursing home market.

We also note that HUD's data systems do not provide reliable data on the types of nursing home projects insured, and thus comparisons with market data are limited.[24] In addition, available market data are based on varying definitions of housing and medical care facilities for the elderly, which further limit analysis. Nonetheless, in its comments, HUD reported that the American Seniors Housing Finance Association and AARP estimate that since 1990, the FHA nursing home program has been responsible for 20 to 25 percent of the loans for seniors' housing for board and care and assisted living facilities. Through discussions with HUD and AARP officials, we understand that this information is based on an undocumented, informal analysis by HUD of incomplete data on the number of FHA-insured facilities and those in the private sector during this time period. On the basis of these data, the Department also expressed the opinion that a similar situation exists for nursing homes but did not provide quantitative support for this assertion.

HUD's response also asserts that FHA-insured nursing home facilities lower the government's Medicaid costs. The Department stated that because FHA-insured borrowers have loans with lower interest rates, Medicaid's capital reimbursement costs are lower. While this may be true, other variables, such as loan term and mortgage insurance premiums, affect total loan costs. Furthermore, while FHA's program may result in savings to the government from lower Medicaid costs, it also carries with it increased risks of losses resulting from future loan defaults.

HUD also provided us with information on the steps being taken to overcome identified management deficiencies and improve its operations, such as moving to a team approach to underwriting loans, upgrading technology and skills through providing computers and software and training, and designing and implementing new information systems for tracking, monitoring, and evaluation. Our draft report recognized that HUD

[24]As a result of our review, HUD has begun separately tracking new nursing home loans in the following categories: nursing homes, board and care facilities, and assisted living facilities.

had a number of initiatives under way, and we have added additional information into the final report on the basis of the Department's comments. However, we still have concerns about HUD's ability to effectively manage the nursing home and retirement service center programs in the near future. The actions being undertaken are in the planning or early implementation phase, and it is too early to know if they will be effective. In addition, the Department's proposed organizational changes and staffing cuts will, at least in the short run, place additional strains on HUD's management capacity, which is currently inadequate to effectively oversee the multifamily loan portfolio.

We conducted our review from September 1994 through July 1995 in accordance with generally accepted government auditing standards. (See app. V for a discussion of our scope and methodology.) We are sending copies of this report to appropriate congressional committees; the Secretary of HUD; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Please contact me on (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix VII.

Judy A. England-Joseph
Director, Housing and
Community Development Issues

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Abbreviations

AARP	American Association of Retired Persons
FHA	Federal Housing Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
UPB	unpaid principal balance

Facilities and Loan Categories Included in FHA's Section 232 Nursing Home Insurance Program

Four types of facilities may be insured by the Federal Housing Administration (FHA) under the section 232 nursing home program. In addition to insurance for the construction or renovation of the four types of facilities provided under the "basic" nursing home loan program, FHA's section 232 loan program also covers other types of loans, such as supplemental loans for additions and improvements to facilities and for the refinancing of loans. FHA also has established categories for insured loans for nursing home facilities that are located in declining urban neighborhoods, processed under the agency's delegated processing program, or processed under the coinsurance program that was terminated in 1990.

Section 232 Facilities

Four types of facilities are eligible for FHA mortgage insurance under the section 232 nursing home program.

Skilled Nursing Facilities—For purposes of FHA's program, a skilled nursing facility is licensed or regulated by the state in which it operates and accommodates convalescents or others who are not acutely ill but who need skilled nursing care and related medical services. The nursing care and medical services provided must be prescribed by or performed under the general direction of licensed personnel.

Intermediate Care Facilities—An intermediate care facility under FHA's program is licensed or regulated by the state in which it operates and accommodates individuals with certain incapacitating infirmities requiring minimum but continuous care.

Board and Care Homes—A board and care home under FHA's program is regulated by the state and provides room, board, and continuous protective oversight. Only a limited portion of the facility's total capacity may be made up of separate independent living units. Board and care homes are generally nonmedical settings that offer a range of services, such as supervision of nutrition and medication, assistance with daily activities such as dressing and eating, continuous responsibility for residents' welfare, or other services.

Assisted Living Facilities—Under FHA's program, assisted living facilities are licensed and regulated by the state and offer a combination of housing, including separate living units and personalized health care for residents who need assistance with activities of daily living, such as bathing, dressing, and eating.

Section 232 Loan Categories

Identified below is each of FHA's loan categories associated with the section 232 nursing home program with loans in force as of September 30, 1994. The number of loans and unpaid principal balances reported for each category are also as of September 30, 1994.

Nursing Homes (Section 232)—FHA's basic section 232 nursing home portfolio consists of 769 insured loans with an unpaid principal balance of $3.3 billion covering the construction or renovation of the various types of facilities approved for the program.

Supplemental Loans (Section 241/232)—The portfolio comprises 28 supplemental loans to pay for improvements to, additions to, or equipment for nursing home projects that already have FHA-insured mortgages. The unpaid principal balance is $62 million.

Coinsurance on Nursing Homes (Section 244/232)—FHA's portfolio includes 10 loans insured under the multifamily coinsurance program, which was terminated on November 12, 1990, and 2 formerly coinsured loans that have been converted to full insurance. The unpaid principal balance is $75 million.

Declining Urban Neighborhood (Section 223[e]/232)—FHA's nursing home portfolio includes 11 loans with an unpaid principal balance of $47 million covering insured mortgages for nursing homes in older, declining urban areas.

Two-Year Operating Loss Loans (Section 223[d]/232)—FHA's portfolio includes 16 2-year operating loss loans with an unpaid principal balance of $8 million. If an FHA nursing home has an operating loss during the first 2 years after the project is completed, FHA may provide insurance for a loan to cover the loss.

Delegated Processing Authority (Section 232)—FHA's section 232 portfolio includes 25 loans with an unpaid principal balance of $167 million processed under FHA's delegated processing program. Under this program, FHA staff work with private mortgage bankers under contract to FHA to process mortgage insurance applications. Delegated processing is intended to streamline the underwriting process while maintaining FHA's control over final underwriting decisions.

Refinancing (Section 223/232)—The portfolio includes eight loans with an unpaid principal balance of $39 million. FHA insures mortgages to refinance

the debt of existing nursing home facilities whether or not the projects were originally financed with FHA insurance.

FHA-Insured Nursing Homes and Total Nursing Homes

The information in table II.1 provides an approximate representation of FHA's role in providing nursing homes in each state and is not sufficient to represent a complete analysis of FHA's nursing home market share, such as what has happened in the market over the last few years. The number of FHA's nursing homes represents the number of FHA-insured mortgage loans (and excludes supplemental and operating loss loans for properties with mortgage loans) for skilled nursing facilities, intermediate care facilities, and board and care homes that were in FHA's insurance-in-force database as of September 30, 1994. The numbers do not include nursing homes previously insured by FHA. The number of total nursing homes in each state represents long-term care facilities providing skilled and unskilled care during 1993, excluding intermediate care, board and care facilities, and assisted living facilities.

Table II.1: FHA-Insured Nursing Homes and Total Nursing Homes, by State

State	Number of FHA-insured nursing homes	Total number of nursing homes	Total nursing home beds per 1,000[a]	FHA-insured nursing homes as a percentage of all nursing homes
Alabama	2	204	42	1
Alaska	0	15	44	0
Arizona	5	130	33	4
Arkansas	5	232	68	2
California	26	1,178	36	2
Colorado	1	188	57	1
Connecticut	9	256	68	4
D.C.	6	18	40	33
Delaware	1	49	55	2
Florida	23	609	30	4
Georgia	9	337	56	3
Hawaii	0	23	17	0
Idaho	1	56	42	2
Illinois	38	778	70	5
Indiana	10	552	89	2
Iowa	7	426	83	2
Kansas	1	368	84	0
Kentucky	13	247	49	5
Louisiana	7	295	77	2
Maine	6	137	60	4
Maryland	21	214	53	10
Massachusetts	55	554	66	10
Michigan	24	422	43	6

(continued)

State	Number of FHA-insured nursing homes	Total number of nursing homes	Total nursing home beds per 1,000[a]	FHA-insured nursing homes as a percentage of all nursing homes
Minnesota	13	385	77	3
Mississippi	14	158	48	9
Missouri	7	549	77	1
Montana	1	68	53	1
Nebraska	1	205	76	0
Nevada	1	30	27	3
New Hampshire	7	80	57	9
New Jersey	31	337	44	9
New Mexico	1	71	40	1
New York	125	572	43	22
North Carolina	41	332	42	12
North Dakota	1	75	73	1
Ohio	72	983	67	7
Oklahoma	21	403	84	5
Oregon	3	168	37	2
Pennsylvania	33	662	48	5
Rhode Island	33	104	68	32
South Carolina	3	157	39	2
South Dakota	1	108	73	1
Tennessee	19	284	55	7
Texas	13	1,116	69	1
Utah	1	85	44	1
Vermont	4	49	54	8
Virginia	70	254	44	28
Washington	12	273	48	4
West Virginia	2	104	37	2
Wisconsin	24	408	74	6
Wyoming	0	26	52	0
Total U.S.	**824[b]**	**15,334**	**55[c]**	**5**

(Table notes on next page)

[a]The "Total nursing home beds per 1,000" column represents the number of nursing home beds per 1,000 people aged 65 and over in that state. The beds per 1,000 column represents long-term care facilities providing skilled and unskilled care during 1993, excluding intermediate care facilities, board and care facilities, and assisted living facilities.

[b]Does not include one nursing home project on the island of St. Thomas.

[c]Represents the national average number of nursing home beds per 1,000 people aged 65 and over in each state.

Source: Data on FHA's nursing homes from the Department of Housing and Urban Development. States' data on total nursing homes, nursing home beds, and beds per 1,000 from Marion Merrell Dow Inc. Managed Care Digest, Long Term Care Edition, 1994 and SMG Marketing Group Inc.

Methodology Used to Evaluate the Financial Performance of the Section 232 Nursing Home Program

Because of the data limitations discussed below, the financial performance of the nursing home program is subject to uncertainty and can only be approximated. To develop an estimate of the actual financial performance of the nursing home program since its inception, we estimated the program's net cash flow for each year, on the basis of the Department of Housing and Urban Development's (HUD) data that can be used to estimate the premium income, claims payments, and recoveries from the sale of either the properties or the properties' mortgage notes.[25] The cash flows were computed on the basis of a comparison of estimated premium receipts with estimated claims payments net of recoveries. Each year's net cash flow was then adjusted to 1994 dollars using the Gross Domestic Product Deflator.

Our analysis does not include the interest cost of federal debt associated with the program nor does it include the interest income that HUD received on some of its assigned loans. HUD was unable to provide complete interest income data. In addition, our analysis does not include the general administrative costs relating to the nursing home program borne by HUD.

Our analysis covers the basic section 232 program, which provides most of the insurance under this program.[26] The basic section 232 program covers the new construction and substantial rehabilitation of skilled and intermediate nursing homes, board and care facilities, and assisted living facilities. As of September 30, 1994, these loans represented 89 percent of the program's unpaid principal balance. Our analysis excludes the other section 232 loans, such as supplemental loans (described in app. I), because they represent a small portion of the portfolio and would be expected to have only a minor impact on the results. Also, our estimates are based on cash flows under the program from 1959 to September 30, 1994, including the estimated recoveries from loan defaults in 1992, 1993, and 1994 that would be received in 1995, 1996, and 1997 according to our cost model.[27] The estimate does not reflect the amounts of expected premium collections or claims payments in the future.

[25]The default costs in this analysis are based on loans that defaulted and resulted in a claims payment following the loan's assignment to HUD.

[26]In HUD's data systems, the basic section 232 program is coded as section 232 "RNF."

[27]In our analysis, we assume that recoveries from the sale of either the properties or the properties' mortgage notes will be received 3 years after the assignment. This is the same recovery period that HUD uses in establishing loan loss reserves for its FHA-insured multifamily portfolio.

HUD's Data Used in Our Analysis

HUD provided us with detailed data on estimated premium receipts by year and the face value of mortgages that had resulted in claims for the basic nursing home program. We used the face value of the mortgages as a proxy for claims payments, since HUD could not provide data on all claims payments since the program's inception. According to officials in HUD's Office of Mortgage Insurance Accounting and Servicing, the face amount of the original mortgages is the best proxy for claims payments. Furthermore, for the nine nursing home properties that went through foreclosure and sale from 1987 through 1994, the cumulative face amount of the loans and the cumulative amount of claims paid were close—$40.4 million versus $40.2 million. We also note that using the face value of the loan to represent HUD's expenditures may produce cost estimates that are more likely to be understated than overstated because HUD also incurs costs while the properties are in the HUD-held inventory. For example, for the nine recent cases for which we have data, HUD's "net investment" in the properties was $43 million, compared with the original loan amount of $40.4 million.[28]

Another data limitation is that HUD does not have historical data on recoveries from the sale of nursing home properties or mortgage notes prior to 1987. We used a weighted average recovery rate of 40.2 percent against total claims of $426 million. (See table III.1.) We assumed 100-percent recovery for $48 million of the claims representing (1) 25 loans[29] totaling $35 million that have been repaid in full and (2) 6 additional loans totaling $13 million in the HUD-held inventory as of September 30, 1994, which had not yet been paid in full but which are classified as operational and current in their payments.

For the balance of the defaulted notes totaling $149 million in the HUD-held inventory as of September 30, 1994, we used the 37-percent recovery rate that HUD used in developing loan loss reserves for its FHA-insured multifamily portfolio as of September 30, 1994, including nursing homes. We used a higher rate than the rate of HUD's actual recoveries for the nursing home program from 1987 through 1994 because HUD management believes that recoveries will be higher than the historical rate as the Department uses foreclosures and property disposition less and increases its use of note sales at foreclosures and third-party note sales upon loan assignment.

[28]HUD's net investment includes claims payments, principal and interest collections while the mortgage is held by HUD, expenses paid for the properties, and property disposition costs incurred.

[29]HUD identified 24 loans that were paid in full and we identified 1 additional loan in the HUD-held inventory as of September 30, 1994, which had been paid in full.

For the cases totaling $229 million for which the note or property sales have been completed, we estimated recoveries on HUD's actual recovery rate of 30 percent for the nursing home program for fiscal years 1987 through 1994. This recovery rate is a weighted average reflecting recoveries on HUD's net investment in the properties and mortgages sold during this 8-year period.[30] The 30-percent weighted recovery rate reflects actual recovery rates of 11 percent for property sales and 44 percent for note sales. Using this rate for all completed sales would tend to understate costs, since most of the sales before about 1987 were handled through property sales. According to FHA's Director of Accounting and Servicing, note sales were rarely used before 1987.[31]

Table III.1: Computation for 40.2-Percent Weighted Average Recovery Rate

	Percent		
Claims category	**Recovery rate**	**Weight**	**Weighted rate**
Repaid 100 percent	100	11	11.0
HUD-held	37	35	13.0
Claims-sold	30	54	16.2
Total			40.2

[30]From 1987 through 1994, note sales were used in 14 cases and property sales in 9. Weighted on the basis of HUD's net investment, note sales represented 58 percent of the cases, and property sales represented 42 percent.

[31]Since 1987, HUD has sold some nursing home loans at foreclosure following a policy change that permitted HUD to accept bids for less than the loan balance.

Nursing Homes Will Be Affected by Efforts to Contain Health Costs and Reform the Health Care System

A substantial portion of nursing home revenue is provided from Medicaid reimbursements.[32] FHA's loan loss reserve estimates do not specifically consider the potential financial impacts of changes in health care policies and reimbursement policies on nursing homes.[33] Although the exact nature of future national changes in health care is uncertain at the present time, the health care industry is currently undergoing significant changes as a result of national and state efforts to contain costs and reform the health care system. Industry and government officials with whom we spoke generally do not believe that proposed and ongoing changes in the health care industry will have a negative impact upon FHA's nursing homes. However, efforts by federal, state, and local governments to control rising health care costs—such as current state and federal actions to reduce Medicaid and Medicare[34] costs—could increase risks and undermine the financial viability of some of these projects.

The view that health care industry changes will not be detrimental to the nursing home industry is based upon the premise that the market for nursing homes will not be reduced, even if alternative housing for the elderly—such as assisted living facilities—becomes more available. Losses to other types of facilities are expected to be offset by hospitals that move patients to nursing homes rapidly to minimize costs and by the overall increase in the elderly population in the United States. However, while market demand for nursing homes may remain stable or increase in the future, the attempts to control medical costs may make it more difficult for nursing homes to remain financially viable. For example, according to officials at the Department of Health and Human Services, skilled nursing homes could face difficulties in covering costs through Medicare and Medicaid as they admit more patients with greater care needs and lose patients requiring less care to other facilities. Medicare and Medicaid reimbursement policies that do not sufficiently compensate for these structural changes in the health care industry could affect the financial stability of nursing homes.

New York provides a good example of the potential impacts of health care reimbursement policies on FHA's nursing home portfolio at the state level.

[32]Medicaid is a joint federal-state program under which the states assume primary administrative responsibility for health care coverage for the aged, disabled, and economically disadvantaged.

[33]The loan loss estimates are based primarily on analyses of the financial and physical condition of multifamily properties, including nursing homes and retirement service centers with FHA mortgage insurance.

[34]Medicare is a health insurance program administered by the Health Care Financing Administration for persons aged 65 or older and for disabled persons who are eligible for care.

The Governor of New York proposed cuts of up to $1.2 billion in the state's Medicaid expenditures for the 1995-96 fiscal year, including a cut of $242.8 million from nursing home reimbursements. While the state budget's final cut in nursing home reimbursements was lowered to $111.5 million, this reduction will increase cost pressures on nursing homes in the state. This issue is pertinent to FHA's insurance portfolio because it includes 136 loans with an unpaid principal balance of $1.2 billion in the state of New York.[35]

In addition, reductions in spending levels for Medicaid are also being considered at the federal level. For example, the federal budget resolution calls for lowering Medicaid spending for the period 1996 through 2002 by $182 billion.

[35]Our upcoming report on FHA's insurance program for hospitals will address the potential impact of Medicaid cuts on hospitals.

Objectives, Scope, and Methodology

As mandated by the Multifamily Housing Property Disposition Reform Act of 1994 (P.L. 103-233, Sec. 103(f), Apr. 11, 1994), we reviewed the role and performance of HUD nursing home and retirement service center programs. Specifically, we (1) evaluated the relationship of these programs to FHA's mission; (2) analyzed information on the programs' financial performance as of September 30, 1994, and assessed HUD's estimates of potential losses under these programs; and (3) evaluated FHA's ability to manage these programs.

To evaluate the relationship of the nursing home program to FHA's mission, we reviewed the legislative history to determine the Congress's intent in passing section 232 of the National Housing Act, which provides insurance for skilled nursing, intermediate care, board and care, and assisted living facilities. We reviewed HUD's regulations and policies to determine how the program was being implemented, and we also discussed the ways in which the nursing home program supports HUD's mission with (1) officials from HUD's Office of Multifamily Housing Management and HUD's Office of Insured Multifamily Housing Development, (2) multifamily staff in three of HUD's field offices, and (3) staff with the Department of Health and Human Services.

We also contacted industry organizations, such as the National Long-Term Care Resource Center, the Health Care Financing Study Group, the Institute for Health Services Research, the New York Association of Homes and Services for the Aging, the Assisted Living Facilities Association of America, and the Sunrise Assisted Living Retirement Community. In addition, we contacted current FHA nursing home insurance program borrowers and lenders to discuss the reasons why FHA financing was used and reviewed studies on the financing of nursing homes and assisted living facilities. Our work primarily focused on issues relating to the extent to which HUD's mission is furthered by the nursing home and retirement service center programs and is not sufficient to determine whether the nursing home program is needed to serve unserved markets. We also did not evaluate the validity of the criticisms of FHA's policies and procedures cited as disincentives to the use of the FHA nursing home insurance program that we received in our contacts and that are also cited in some articles we reviewed.

For the terminated retirement service center program, we reviewed the regulations terminating the program that had been created by HUD as part of an existing multifamily housing program and the 1990 program studies by HUD's Inspector General and HUD's Office of Policy Development and

Research.[36] We also visited HUD's Minneapolis, Minnesota; San Francisco, California; and Jacksonville, Florida, field offices to obtain detailed information on FHA's nursing home and retirement service center programs.[37]

To provide information on the programs' financial performance as of September 30, 1994, we met with officials from HUD's Office of Housing-FHA Comptroller in August 1994 and requested cumulative financial performance data (covering program receipts and expenditures) for the nursing home and retirement service center programs. While the Comptroller's office did provide some information in December 1994 and February 1995, it was not sufficient to determine the financial performance of these programs. Subsequently, on the basis of discussions with HUD's Director, Multifamily Accounting and Servicing Division, and a staff member from HUD's Statistical and Actuarial Analysis Staff (Office of Policy, Planning, and Financial Systems Enhancements), we obtained data on the nursing home program that these officials believed could be used to provide an estimate of the financial performance of this program since its inception. We did not verify the reliability of HUD's nursing home data. The scope and methodology of our analysis are summarized in appendix III.

Because automated data are not available on the retirement service center program, HUD did not provide comparable data that would have enabled us to perform a similar analysis of the retirement service center program's financial performance as we had done for the nursing home program.[38] Accordingly, our assessment of the program's financial performance was limited to a review of HUD's data on the program's default rate and the related face value of loans that have defaulted. We did not verify the reliability of HUD's data on the retirement service center program in HUD's July 12, 1995, report, Retirement Service Centers, by Richard G. Calvert, Thomas N. Herzog, James E. Laverty, and Darrel S. Connelly, Statistical and Actuarial Analysis Staff, HUD. We also reviewed the financial performance data in the HUD Inspector General's 1990 study of this

[36]Multi-Region Audit of the Insured Retirement Service Centers Program, Office of the HUD Inspector General, 90-TS-111/112-0008 (Apr. 6, 1990) and Retirement Service Center Program Evaluation, HUD Office of Policy Development and Research (June 1990).

[37]HUD officials in the Office of Multifamily Housing Management said these field offices would have loans representative of HUD's inventory of nursing home and/or retirement service center projects.

[38]The retirement service center program—a subprogram of a market-rate multifamily insurance program—does not have a subcode associated with it in HUD's data systems. Without a subcode, which would identify this subset of loans, information on the individual retirement service center loans would have to be gathered manually and input individually into a database to generate reports on the program.

program and the study conducted by HUD's Office of Policy Development and Research in 1990.

To assess HUD's estimates of future potential losses under these programs, we reviewed information from FHA's fiscal year 1993 and 1994 multifamily loan loss reserve analyses that establish loss reserves for estimated future losses stemming from loan defaults. We also used information from our review of FHA's fiscal year 1993 loan loss reserve analysis.[39] Because FHA's loan loss reserve analyses do not provide a separate loss estimate for retirement service center loans and FHA analyzed only eight retirement service center loans as part of the fiscal year 1993 loan loss estimate, we used an alternative approach to estimate potential losses for retirement service centers. This approach was based primarily on estimates of the potential for future defaults from loan servicers in the HUD field offices with responsibility for insured retirement service center projects. Working with HUD staff, we identified 108 retirement service center loans in force as of September 30, 1993. In November 1994, we sent standardized questionnaires to the 32 cognizant HUD field offices for each of the 108 retirement service center projects. Of these 108 projects, respondents told us that at the time of our survey, two loans had been paid off and four projects were not considered to be retirement service centers. We obtained responses for all, or 100 percent, of the remaining 102 retirement service centers. We also reviewed the 1993 financial statement analyses of 90 FHA-insured retirement service centers performed by a contractor for HUD in 1994.

To evaluate FHA's ability to manage these programs, we reviewed relevant HUD Inspector General, Price Waterhouse, and GAO reports on HUD's multifamily loan management, including reports on the nursing home and retirement service center programs. We also used our June 5, 1995, report, cited above, to provide us with up-to-date information on HUD's initiatives to prevent defaults. In addition, we reviewed HUD's reinvention proposal and budget request and discussed management issues with officials in HUD's Office of Multifamily Housing Development and in the three field offices visited.

We performed our review at HUD's headquarters in Washington, D.C., and at HUD's field offices in Jacksonville, Minneapolis, and San Francisco.

[39]HUD Management: FHA's Multifamily Loan Loss Reserves and Default Prevention Efforts (GAO/RCED/AIMD-95-100, June 5, 1995).

Comments From the Department of Housing and Urban Development

U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

Ms. Judy A. England-Joseph
Director, Housing and Community
Development Issues
United States
General Account Office
Washington, DC 20548

AUG - 2 1995

Dear Ms. England-Joseph:

The Department has reviewed the draft of your proposed report entitled HUD Management: FHA's Nursing Home and Retirement Service Center Programs (GAO/RCED-95-214) and are submitting the comments outlined below. At the outset, we want to reiterate that the inclusion of Retirement Service Centers (RSC) with the Section 232 Nursing Home (NH) program is misleading and does not appropriately distinguish between the operations or status of these two separate insuring authorities. The Department placed a moratorium on the RSC program in 1989, 7 years ago, because of obvious program flaws that have been covered at length in other internal and external reports. The RSC program was formally terminated in 1991. Outstanding issues with RSCs relate primarily to those projects still remaining in the portfolio.

While we recognize the GAO's charge in the Multifamily Housing Property Disposition Reform Act of 1994 to report on the NH, RSC, and hospital programs, we continue to believe that the RSC program report should not be commingled with the Section 232 program, as the hospital report is not so commingled.

Nursing homes and RSCs are clearly unrelated products as are nursing homes and hospitals. It appears that the reason that NHs and RSCs are the subject of the same report is because the Section 232 program, under which NHs are insured, also provides authority to insure related residential health care facilities - board and care homes (B&C) and assisted living facilities (ALF). The report incorrectly assumes that RSCs and B&C/ALFs are quite similar products. However, the market and operations of RSCs and B&C/ALFs are, in fact, specifically different so there is no basis for including RSCs in a report about the Section 232 program.

RSCs and B&C/ALFs are different products serving different markets.

People enter a B&C/ALF only when they can no longer remain fully independent and need the support and health related services offered by these facilities (i.e., assistance with the

activities of daily living such as eating, dressing, medications, bathing, walking, getting in and out of bed, going to the toilet, and other personal care, etc.). Because most B&C/ALF occupants are frail, they must seek out service-based facilities at this point. RSCs, on the other hand, were not permitted to offer health-type and personal care services, since they were insured under a section of the National Housing Act that does not permit such services.

Because RSCs could only provide basic services (primarily meals and housekeeping), elderly households could elect not to incur the monetary and emotional costs of moving from their homes. The program design assumed that the RSC product would appeal to the frail elderly when, in fact, RSCs did not include the care and services that the frail elderly market requires. RSCs were very much "demand driven" rather than "need driven." RSCs appealed mainly to a relatively independent (and well-off) segment of the elderly population which had a variety of options, including staying in their own homes.

The report also notes that there are other attributes besides the health and personal care services provided that differentiate RSCs from B&C/ALFs. The most important of these is the requirement for State licensing and oversight of B&Cs and ALFs. While this oversight may not guarantee the financial status of the project, as stated in your report, it does ensure that the high level of care and services evidenced by the licensing is the level of care and services provided - i.e., that the project will be operated as a B&C or ALF with the health care component. All 50 States have a category for licensing facilities that provide such services and support facilities.

Significant changes are planned and underway to improve Federal Housing Administration operations.

Most critically, let me suggest that we appreciate your observations to improve the delivery of insurance and move to a self-sustaining operation. As you know from previous conversations, the Department is acutely aware of problems with past and current programs and the difficulty of operating with an outdated organizational structure and outdated technology. FHA instituted a major reorganization of our field operations along our two major product lines, Single Family and Multifamily, and placed our loan origination and asset management activities under a director directly accountable to the Federal Housing Commission in December 1994. As a result, our program delivery systems now incorporate team operations, coordination and the long-term view and integrated approach to our business that has often been absent in the past.

Secondly, the Office of Multifamily is engaged in analysis of current programs, including the Section 232 program encompassing NHs, B&Cs and ALFs, and redesign of product lines to ensure that standards and requirements are appropriate and will move FHA toward self-sustaining operations. These efforts are part of FHA-Multifamily's business strategic planning.

The Business Strategic Plan (BSP) was completed in November, 1994. It defined our mission - to build better neighborhoods by supporting communities by maintaining and expanding residential choices (including residential health care choices) and improving our portfolio. The BSP also defined strategic issues and specific goals and objectives to support that mission. As part of implementation of these objectives, a series of forums was held with partners and stakeholders to develop and refine the BSP to make it operational. Participants included representatives of various industry groups (including health care), mortgagees, nonprofits, secondary markets, community development corporations, affordable housing lenders, and others using FHA programs.

As a direct outgrowth of these forums, FHA-Multifamily has moved forward directly with the next steps of implementation (BSPII) which includes, among other things, design of product lines that will make FHA self-sustaining. A team is currently redesigning the program for nursing homes and other residential health care facilities. Changes under consideration relate not only to fees and premiums but also to basic underwriting considerations such as reductions in loan-to-value limits, shorter mortgage terms and similar changes that would clearly put current programs into a positive cash flow posture.

The point about how FHA Multifamily is changing the way it does business is an important one. The past cannot be changed but the past can provide many lessons for the future. Over the last 3 years, FHA has learned lessons that are relevant to all of FHA's multifamily programs. Some of these lessons learned have already resulted in changes. Examples are:

-- A move to a team approach to underwriting which includes production as well as asset management members.

-- Upgrading of technology and skills through provision of computers and software and training.

-- Design and implementation of new information systems for tracking, monitoring and evaluation.

-- Sales of HUD-held mortgages which increase the recovery rate, improving the financial position of the FHA fund. Sales sent a message to owners that mortgages may be sold

when assigned, giving owners an incentive to keep their mortgages current and in the insured inventory. Previously, being HUD-held meant less, not more servicing. However, when a mortgage is sold by HUD, the defaulted owner is subject to increased enforcement by the purchaser, including foreclosure. The Department is planning the sale of 50 HUD-held nursing homes in 1996.

-- Tracking and follow-up with owners on financial statement submission requirements is being implemented. A contractor has been hired to remind owners of their obligations, follow-up on nonsubmissions, enter received information into a database, provide downloads of information to the Field Offices, rate the financial health of the properties whose statements are reviewed and entered into the data system, and identify - for further action by the Department - those owners who failed to submit the required statements. Field staff will be able to utilize the information to identify troubled and potentially troubled properties in their portfolios.

-- Consolidation of certain routine asset management functions to free staff to focus on the troubled and potentially troubled properties, including health care facilities. Part of this consolidation will include training on the nuances of health care facilities which are different from traditional multifamily facilities.

Enclosed are the Department's responses to other comments in the subject report.

Sincerely,

Helen Dunlap
Deputy Assistant Secretary for
Multifamily Housing Programs

Enclosure

ENCLOSURE

In addition to the important points relative to Retirement Service Centers and recent and on-going changes in FHA operations made in the letter transmitting this enclosure, the following comments are offered:

FURTHERANCE OF HUD'S MISSION
BY PROGRAM IS UNCERTAIN

1. **Nursing Homes Further HUD's Mission.** HUD's mission is far broader than just housing. HUD's mission is to help cities and localities prepare for the future, bring housing and homeownership to millions of citizens, and to protect poor and vulnerable populations. The nursing home program furthers HUD's mission by providing a broad range of housing and needed services for elderly and other vulnerable groups who cannot live independently. This includes low income elderly people and those in unserved and underserved urban, suburban and rural areas. While is it true that there is no specific analysis relative to location of insured nursing homes in unserved and underserved areas, insured nursing homes are a important source of housing for the low income and other elderly people. With respect to low income elderly, nationwide, approximately 65 percent of all nursing home beds are occupied by Medicaid patients - all of whom must meet the federal definition of indigent. Although we have no specific data on the percent of Medicaid occupants in insured properties, it is at least this high for FHA properties and probably higher than the national average.

   The situation with B&Cs, and now ALFs, is somewhat different with respect to low income housing because they are primarily market rate facilities for moderate income to more well off elderly persons. However, B&Cs and ALFs serve frail elderly persons and other vulnerable groups by providing continuous protective oversight and many needed services. They also provide a type of housing that is growing as the population ages and families (and States) look to cheaper alternatives to nursing homes. These facilities are being built in a variety of locations across the country and provide a resource for the communities in which they are built.

   The nursing home program also furthers HUD's mission by providing financing for NH mortgagors/owners who would otherwise be unable to obtain financing at reasonable rates. FHA-insured properties are largely stand-alone facilities which the conventional market generally does not serve. Industry sources advise that neither of the two major rating agencies (Standard and Poors and Moody's Investor Services) rate stand-alone NH financings. Likewise, the major national municipal bond insurance companies (MBIA, AMBAC,

FGIC, FSA) also do not rate stand-alone NH financings. FHA credit enhancement allows these types of facilities to obtain investment grade financing to develop feasible projects to serve low income occupants.

Absent FHA insurance (or a guarantee from an investment grade affiliated credit such as an affiliated hospital corporation), the vast majority of FHA-insured nursing homes would either not be able to obtain investment grade financing or, if they could obtain financing at all, would find the cost of that financing to be below investment grade. This means financing with "junk bond status" at interest rates at least 200 basis points, or 2.0 percent, above FHA insured financing rates.

Since Medicaid is the primary payor for skilled nursing care, the federal government (via its share of the reimbursement of Medicaid capital costs) has been a very significant beneficiary of the cost savings generated because of the interest rates facilitated by FHA insurance. For example, if only $2 billion of the $5.1 billion of Section 232 loans endorsed by HUD saved 200 basis points as a result of FHA insurance, the annual interest cost savings on these loans approximates $4 million per year.

2. **FHA's Market Share.** As to FHA's share of the market, comparison should be made to what has been happening over the last few years. In the years from 1990 to 1994, FHA insured 324 projects under Section 232. Approximately 75 projects are under construction at any give time. Only a comparison with the amount of conventional financing done in a similar time period could truly demonstrate trends in FHA's nursing home share. The American Seniors Housing Finance Association and the American Association of Retired Persons estimate that since 1990, the Section 232 program is responsible for 20 to 25 percent of the loans for seniors housing for B&Cs and ALFs. It is likely that a similar situation exists for nursing homes inasmuch as Section 232 is one of the few sources of both construction and long term fixed-rate financing in today's capital markets, especially for stand-alone facilities. Projects developed by health care chains and the larger operators are able to obtain financing from commercial banks and other sources.

3. **RSC Program and Private Sector Served Same Market.** HUD takes no exception to the description of the RSC program in this section. As stated previously, the saga of the RSC program has been covered in detail in many venues, and the

Department placed a moratorium on new RSC business 7 years ago. Because RSCs are a different product as outlined in detail in the letter accompanying this enclosure, the Department reiterates that they should be covered in a separate report.

FINANCIAL DATA AND HUD ANALYSIS
INDICATE PROGRAM LOSSES

4. **Programs (NH & RSC) have incurred losses to date.** The RSC program unquestionably has incurred significant losses. The program was implemented and its demise occurred within the last 10 years, so more information is known about the RSC portfolio. The program was terminated as a result of these losses as stated previously.

The data limitations noted by the report make statements about the NH program more problematic. The fact is, for example, that recoveries were not tracked until 1987. In addition, because of vast changes in society and the health care industry, the NH program of 20 or 30 years ago is not the NH program of today. The Abt study, which reports on recent status of the Section 232 program (January 1987 through September 1994) shows that 403 projects were endorsed during that period. Twenty seven resulted in claims for a claims rate of 6.7 percent for this period. According to HUD's actuarial staff reporting on claims from program inception in 1959 through September of 1993, the overall claims rate is 8.8 percent.

In the last 3 years, however, FHA has taken, and is continuing to take, steps to manage its portfolio, address longstanding problems, and put FHA on a self-sustaining basis. This includes revising program requirements when problems arise, such as state laws or procedures that may lead to reduction of number of beds. For example, a default due to the voluntary reduction of beds by a nursing home lessee to satisfy State demands led to changes in the Regulatory Agreement to require that no reduction to the number of beds may be made without written approval of HUD. Under no. 6, below, there is further information about improvements to asset management and oversight.

5. **Credit subsidy estimates may be inadequate.** Credit subsidy estimates are a subject of continuing discussions with the Office of Management and Budget. This fall, the Department will be engaging with OMB on all the credit subsidy rates. As better data are obtained (information systems are in the process of being significantly upgraded) and more experience is gained with recoveries, note sales, etc., numbers can be refined and revised as appropriate. The Abt report to which

you allude shows a very slight negative cash flow for the NH program in the last few years. However, the Abt report also states that changes to the NH program would make the program self-sustaining. As part of its Business Strategic Plan, FHA Multifamily is in the process of revamping its product lines. We anticipate significant changes and product availability by the end of Fiscal Year 1996. Changes may include reduction in mortgage terms, lower loan-to-value ratios, higher fees and premiums, etc.

PROGRAM AND AGENCY CHANGES MAY FURTHER STRAIN FHA'S MANAGEMENT CAPACITY

6. **HUD's multifamily loan portfolio not adequately managed and program expansion may further strain oversight ability.**

We appreciate this important observation and caution. We are taking numerous steps, however, to ensure that our oversight is strengthened. As part of the effort to improve the management and oversight of the multifamily portfolio, management staff in Headquarters and the Field are working as a team to develop a set of early warning indicators to identify troubled and potentially troubled properties, with a job aide encompassing all indicators of problems, financial and otherwise. This effort should be completed by the end of this Fiscal Year. In addition, a Loss Mitigation Job Aide was approved and issued to the Field Office staff on July 18, 1995.

Financial Statement submission requirements are being strengthened and enforcement actions taken against owners who fail to comply with the requirements.

A system has been developed, and is ready for testing, which would provide for electronic reporting by mortgagees of delinquencies and defaults directly to Headquarters and the Field offering a real time opportunity for multifamily staff in the field to work with owners and mortgagees to prevent the mortgage from being assigned. This effort, coupled with servicing function consolidation and note sales should free multifamily staff time to focus on the insured portion of the inventory, including the Nursing Home/B&C/ALF segment.

Lastly, the Department has launched an aggressive program to sell the mortgages it holds as a result of assignment. This program should serve as an incentive to owners to keep their mortgages current. When a mortgage is sold by HUD, there are no guarantees that the purchaser will not take action against the defaulted owner, including foreclosure.

7. **Assisted Living Facility (ALF) and Board & Cares (B&C) are riskier than NHs.** Since ALFs and B&Cs do not generally

receive federal health reimbursements such as Medicare or Medicaid, proper underwriting is paramount for these properties. A recent study of claims since 1986 shows that about one-third of the claims (10 of 30) are for B&Cs, which the Department believes do not represent one-third of the business during the same period. A survey of Field Offices regarding these loans revealed that the two most common reasons given for project failure were inexperience of the sponsor in the frail elderly field and misjudging the market, particularly regarding length of rent-up periods and the inability to rent double occupancy rooms. However, several of these projects have recovered financially and are making payments or were sold with a small loss. In one case, the State retroactively reduced the maximum number of units permitted in a B&C with no grandfather clause for projects under construction and in two cases, fraud led to project failures.

FHA Multifamily plans to address these issues and provide training and skills reinforcement to Field Office staff on ALFs/B&Cs in August. The training presenters will include representatives from the assisted living industry, and FHA technical and program staff. This training will cover, among other things, the importance of dealing only with experienced developers and operators, examining carefully the market and what is accepted in the marketplace, and other underwriting and operational issues. In addition, advanced valuation training, including valuation for the Section 232 program, will be offered in Denver for staff from several Field Offices on 3 days in August. This training will emphasize market and marketability issues for NHs, B&Cs and ALFs.

8. **Other activities.** In additions to the upcoming training on ALFs and Section 232 valuation, the Department has taken several steps in the last few years to improve knowledge and understanding of the Section 232 program. In March 1992, there was "Advanced Multifamily Valuation Training" conducted for Field Office staff that included a component on NH valuation. During the summer of 1992, there was another training program conducted for the Delegated Processing contractors. In September 1992, the Nursing Home and Residential Care Handbook was issued, expanding and updating the previous 1973 edition. In 1993, there was a

Medicaid study conducted by the University of California, San Francisco that described in detail various aspects of the Medicaid and reimbursements. The results were shared with the Field in the form of a Medicaid Data Book for their use in underwriting. In February 1994, there was a program for the Headquarters staff on Medicaid/Medicare reimbursement. In January 1995, HUD issued a revised Handbook 4600.1 REV-1, Change 1, that covers the ALF program and the 223(f) refinance program.

RECOMMENDATIONS

The report recommends that FHA Multifamily "(1) collect data on the characteristics of patients, locations and borrowers for all future projects [to ensure that we are serving the target population]; (2) use the receipts and expenses data now tracked by HUD's data systems to monitor the program's financial performance; (3) reformulate credit subsidy estimates for nursing home loans on the basis of data that are up-to-date, accurate, and, to the extent possible, take into account differences between the potential default risk of loans that are to be insured and loans that have been insured in the past, and (4) establish procedures to carefully monitor the financial performance of ALF loans in the nursing home portfolio in a timely manner so that prompt action may be taken to prevent future loan defaults."

Response. As stated previously, FHA-Multifamily is implementing our strategic plan that includes building a strong, market-oriented multifamily housing finance market, redesigning products to ensure a self-sustaining FHA, monitoring the financial performance of FHA programs and implementing a variety of remedial actions based on lessons learned from past practices. Major implementation actions will be carried out in Fiscal Year 1996. Specific steps taken or underway are:

-- Preparation of new products to submit to Congress this fall.

-- Working with OMB on credit subsidy adjustments.

-- Consolidating asset management and underwriting in the Field.

A major effort at this time to collect data on characteristics of patients, locations of projects and borrowers is overly burdensome and counter to the direction of reinvention. Furthermore, as discussed in comment no. 1, Section 232 is largely targeted to an indigent Medicaid-eligible population. In addition, insurance is made available to borrowers who could not otherwise obtain financing at reasonable rates.

This information is not collected for other FHA insurance programs except for projects that receive some sort of HUD subsidy. There is nothing in the legislation that directs the Department to target certain areas or even certain populations except within the statutory underwriting limitations (e.g., limiting mortgages to 90 percent of FHA-appraised value).

The aging of the Nation's population has significant implications in terms of future needs for long-term care. With the changes underway and those contemplated in the near future, the new FHA must and will be ready to meet the demands of this challenge.

Miscellaneous comments.

1. In mentioning HUD's actuarial studies, e.g., the RSC study mentioned on p. 4, the full citation of the work should be given including the title of the papers and authors. This will enable readers to obtain this material easily.

2. The papers on RSCs and Section 232s done by the actuarial staff are being revised to reflect new data.

3. Accounting staff notes that 11 of the RSC claims in the report were either reassignments or bond refunders, as follows:

Project number	Reassignment amount
034-35225	$10,567,723.87
046-35589	15,648,120.90
046-35590	2,960,656.33
053-35491	6,122,096,85
053-35578	9,030,252.36
071-35513	13,482,711.00
073-35485	5,096,401.39
086-35193	3,458,834.98
087-35151	3,987,004.82
092-35443	9,976,221.49
123-35169	13,482,090.43

Six of the claims were partial claims.

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