FEATURE STORY

Alan J. Spidel

what's new with the FHA's Section 242?

The federal government is working to increase awareness of a 40-year-old mortgage insurance program that could be just what borrowing hospitals need in this time of tight credit.

AT A GLANCE

- FHA hospital mortgage insurance, also called the Section 242 program, acts as a credit enhancement that allows borrowers to issue bonds up to the equivalent of an "AAA" rating, with the benefits of lower interest rates.
- Although the program has operated in relative obscurity over its 40 years of existence, the FHA has undertaken a new marketing campaign to raise its profile.
- Federal backing may make the program an attractive option amid today's financial turmoil in the capital markets.

The Federal Housing Administration's (FHA) hospital mortgage insurance program has committed to insure 366 mortgages worth $14.2 billion, and still some hospitals have never heard of it. But as municipal or monoline bond insurers have been downgraded and credit is more difficult to come by, recently implemented FHA marketing efforts are finding an audience whose capital needs are multiplying at the speed of technological innovation, and whose borrowing options are being cramped by wider credit spreads and withered market liquidity. These converging factors could finally propel the hospital mortgage insurance program into the collective consciousness of hospitals nationwide, 40 years after the program began.

FHA hospital mortgage insurance is known to lenders as the FHA Section 242 program, after the section of the National Housing Act of 1968, under which it was created. The mortgage insurance acts as a credit enhancement, offering borrowers the opportunity to issue bonds at up to the equivalent of an "AA" or "AAA" rating, and the benefits of lower interest rates. The reduced cost of borrowing, and a 25-year payment period, can give hospitals better opportunities to service debt and make it possible to borrow more for renovations or new construction. Refinancing also is an option if at least 20 percent of the funds go toward new projects.

The program is available to—and has been used by—the broad range of hospitals from large systems to critical access hospitals (CAHs), both public and private, for-profit and not-for-profit.

Project loans as high as $600 million have been insured; one hospital has a total aggregate loan balance, including supplemental loans, in excess of $1 billion. The application pipeline includes a hospital with $265 million in cash and a high 224-days-cash-on-hand ratio, as well as several CAHs.

Read the author's comments about the impact of the current financial crisis and its relationship to the FHA 242 program at www.hfma.org/hfm.

Yet the program has had a surprisingly low profile over the years. FHA relied on lenders to spread the word; but until recently, only a handful of lenders offered 242 mortgage insurance, and the program insured an average of only five new hospitals annually from 1995 to 2006.

A little over a year ago, while homebuyers were still riding high on interest-only mortgages and the healthcare credit spread was so tight that even average-to-low credits could afford to issue unenhanced bonds, FHA embarked on its first-ever formal marketing plan to attract attention—and business—from hospitals with capital projects. The campaign is promoting a federal team comprising former hospital CEOs and CFOs, streamlined applications that challenge the slow boat stereotype of working with the government, and a cost of capital that isn't always available through other means, even if it may come with higher upfront costs and federal oversight.

Demand for alternative sources of credit enhancement is increasing along with awareness of the 242 program. Hospital borrowers face an uncertain reimbursement environment, and some have difficulty maintaining a credit rating given the size of their projects. On the market side, investors are no longer confident that bond insurers could pay out should a borrower default. Hospitals that previously turned to monoline bond insurers for enhancement now may choose to turn to FHA instead.

Older hospitals, in particular, cannot wait for strong capital markets. A 40-year-old hospital won't stop needing renovations and upgrades just because the credit market dries up. Under such circumstances, the FHA mortgage insurance program can give a hospital access to affordable capital and can provide relatively low interest rates for a long-term period. Hospitals that access the program also can gain supplemental financing through the FHA Section 241 program for future capital needs, without refinancing the original Section 242 loan. As the markets have shifted, the value of 242 mortgage insurance is in the millions of dollars.

Opening the Door

To increase awareness of the 242 program, FHA is focusing on attracting and educating new lenders (which must be FHA-approved to offer the program), working with state hospital associations to explain the program, exhibiting at hospital conferences, and advertising in healthcare magazines. It also has made moves in the past several years to increase program eligibility.

Prior to the recent marketing push, FHA had done relatively little to actively promote the program "We had never made a conscious effort to spread or market the program," said William Lammers, health systems adviser for the Office of Insured Health Care Facilities of the U.S. Department of Housing and Urban Development (HUD), which administers the FHA 242 program.

The program wasn't even easily accessible in every state, partially limited by its own regulations. The National Housing Act originally stated that the 242 program could be used only by hospitals that had received a state-issued certificate of need (CON)—a restriction that effectively disqualified hospitals in states without CON policies, many of which have repealed them since the act was written. In 2003, the act was amended to permit hospitals in non-CON states to qualify. Further amendment opened up Section 242 to more rural hospitals with nursing beds by waiving, for CAHs, the requirement that no more than 50 percent of revenues be attributable to certain subacute services.

Geographic diversification also was an issue. As recently as 2000, 89 percent of the program's outstanding mortgage balances were in New York state. In the past several years, the majority of commitments issued have been in other states, thereby reducing the portfolio concentration and risk for FHA. Although 55 percent of the portfolio is still in New York, the program has expanded and insured mortgages in 42 states. "We're also recruiting and interviewing new staff," says Lammers. "We've had classified ads in *hfm* magazine and HFMA's web site and a number of other places around the country."

Section 2-4-Who?

The awareness campaign is battling not only hospitals' lack of knowledge of the program, but also the failure of lenders, which typically make hospitals aware of their financing options, to alert hospitals to the program's existence. Some lenders may not know to include the 242 program, while others may not be FHA-approved to offer it. Therefore, rather than start off its marketing with advertisements, FHA decided to focus initially at the lender level, holding training programs with mortgage bankers.

"We found that if we can train the mortgagees, we're in a much better position," said Steven Hunt, senior account executive for HUD's Office of Insured Health Care Facilities. "We are then able to expand out because lenders are the kind of people who are talking directly to the leadership of the hospitals." The campaign now includes advertisements, trade show exhibits, and education sessions at hospital conferences. And although the office has insured eight loans in 2008, it also has completed 30 preliminary reviews—more than in 2006 and 2007 combined—and has 13 active or anticipated applications representing $1.6 billion more.

Getting the word out, though, is only one step for a financing option with the stereotypical hurdles of a federal program.

Stripping Away the Red Tape

The awareness campaign coincides with internal pushes to improve administration of the program and its historically lackluster reputation for being a slow option. Approval times have been reduced, and 242 is beginning to track more quality benchmarks, addressing several critiques from a 2006 report from the Government Accountability Office (GAO), *Hospital Mortgage Insurance Program: Program and Risk Management Could Be Enhanced*.

From 2002 to 2005, according to the GAO report, FHA received no more than 10 applications, but never processed more than two a year within its goal of 120 days. In 2005, the median processing time for the eight loans insured, from FHA's receipt of a complete application to issuance of a mortgage commitment, was 224 days.

Since then, FHA has added staff with hospital backgrounds and streamlined its application process, completing three of eight 2008 loan approvals within the 120-day goal. "What we're trying to do is reduce the bureaucracy to the extent that we can, once the applications have been submitted for processing," says Hunt. The median processing time for those eight loans, he says, was 115 days. Reduced application time means less hospital exposure to fluctuating interest rates and rising construction costs.

Part of that streamlining process has included bringing the 242 program entirely under control of HUD and the FHA. Until 2007, FHA offices worked with the Department of Health and Human Services to process applications.

"There was a certain amount of inefficiency with having two agencies involved," says Michael Mazer, senior partner for Krooth & Altman, commenting on his law firm's experience in dealing with FHA 242 transactions, which extends back to the 1970s. "Now, we have no bureaucratic tensions between two federal agencies, and no redundancies. That in turn has led to opportunities to manage the program, control the product better—from the point of view not only of quality, but also of timeliness."

Playing Against Type

Adding efficiency and value to the process are the former hospital CEOs and CFOs now working on FHA's team. The people evaluating hospital applications are former hospital leaders; Lammers himself was CFO of a Catholic health system for 17 years. Having staff with such experience, including a deep understanding of hospitals, is somewhat of a departure from the program's practice of 10 years ago. This change has ensured the program's staff can hone in on the issues that are of real concern to hospitals, and address those issues more rapidly than it had in the past.

"I expected government bureaucrats, actually," said Earl Fitzpatrick, CEO of Gooding County Memorial Hospital in Idaho, which recently received FHA's

242 Mortgage Insurance at a Glance

Eligibility

Acute care hospitals with no more than 50 percent of revenues attributable to certain subacute services (not applicable to critical access hospitals [CAHs]). The average operating margin must be positive over the past three years, with a debt service coverage ratio of at least 1.25. Newly designated CAHs may recast their financial statements to reflect three full fiscal years of CAH reimbursement.

Loan Amount

The loan-to-value ratio may not exceed 90 percent of the project value, but project value is calculated so that the debt available may meet 100 percent of the project cost. There is no maximum loan amount.

Term

Up to 25 years after completion of construction interest-only period. Interest rates are fixed.

Funding Options

Not-for-profit hospitals can use mortgage insurance as a credit enhancement to issue tax-exempt bonds. Depending on market conditions, a commercial bond insurer may be used to achieve an "AAA" bond rating. Not-for-profits may also elect to issue taxable notes without a bond issue in conjunction with "AAA" Ginnie Mae guaranteed mortgage-backed securities. For-profit hospitals can use mortgage insurance in conjunction with Ginnie Mae mortgage-backed securities to issue taxable collateralized securities.

Liability and Security

Loans insured by the 242 program are secured by a real estate mortgage and a pledge of revenues related directly to the project. Collateral pledged for 242 program loans may not be part of an obligated group or be used as collateral for other debt. Loans are non-recourse to parent or affiliated entities, and hospitals may qualify to transfer excess cash flow to parent health systems or hospitals. The hospital must grant the 242 program lender a first mortgage on the entire hospital, including all real estate and improvements. (Possible exceptions include leased equipment, off-site property, capital associated with affiliations, and city- and/or county-owned facilities.)

Expenses

Fixed closing costs:
> 0.30 percent FHA application fee
> 0.50 percent FHA inspection fee

Fixed transaction costs:
> Davis-Bacon construction wages

Variable closing costs:
> 2.00 percent to 5.50 percent for financing expenses (including mortgage bankers, investment bankers, attorneys, and rating agencies), determined by the final transaction
> $50,000 to $125,000 for an examined financial forecast by a qualified accounting firm

Annual expenses (based on outstanding principal):
> 0.50 percent annual FHA mortgage insurance premium

242 PROGRAM PHASES

Phase	Purpose	Estimated Time
Preassessment	Provide HUD with basic information on project.	First month
Preapplication	Arrange visit to HUD's headquarters for half-day meeting to present and discuss project details.	Second month
Application	Complete full application for HUD's review, including a financial examination. After submission, HUD's goal is a 120-day application processing period.	Third through eighth month
Closing	Complete funding documentation and issue debt.	Ninth month

Source: Lancaster Pollard.

commitment to insure a $27.6 million mortgage to replace its 40-year-old CAH. "It's been a very smooth process because they actually have people who are in the industry, specifically prior hospital administrators, people who have worked in and for hospitals before. And that's a huge plus. You have to go in there with factual information, but you don't have to go in there and get into details, because they at least understand the situation you're in—understand hospitals as a whole."

The "F" in FHA

That's not to say the process is easy—just that it's easier than expected. As federal programs, FHA loans do carry more oversight than traditional financing sources. It's a reason some hospitals choose to finance through FHA initially, and then refinance out of the program once they have established greater financial stability.

Portage Health System in Michigan financed its $24.4 million facility with the 242 program in 1998, combining the federal mortgage insurance and bond insurance to issue bonds at the equivalent of an "AAA" rating.

"That was a good experience as we got started," says Jim Bogan, Portage's CEO. Portage's executive team doubted the hospital could get a good rating on its bonds on its own at the time, and they determined 242 was the most cost-effective option because the long-term, low interest rate would offset upfront costs. Bogan notes, however, that although the 242 program initially reduced Portage's long-term cost of capital, the program's inflexibility in adding debt caused difficulties.

Portage needed to make a $6 million addition, but the hospital did not want to use FHA's supplemental Section 241 program because of the upfront costs on the small dollar amount. Because FHA had a first mortgage on the hospital, Portage could not use the new addition as collateral. It had to put up an off-site facility as collateral to get a local bank loan for the addition. By 2006, Portage had refinanced out of the program.

"Many of the hospitals, frankly, have gotten stronger over time and paid off the mortgage and gone on to other financing options," says Steven Hunt. Of the 74 hospitals insured by the Section 242 and 241 programs from 1986 through 2006, 56 are still active HUD loans. Nationally, most bonds in general are not carried to maturity, and hospitals remain in the FHA program for various reasons, including the ability to add supplemental Section 241 debt. FHA has made changes since Portage's refinance, including making efforts to be more responsive on the postcompletion asset management side.

Best Practices for 242 Applicants

When asked to name the most important element in a successful FHA 242 application, attorney, hospital, and FHA representatives alike point to working with an experienced team to assemble comprehensive pre- and full applications.

"Ninety percent of it is driven by the qualifications of the mortgage banker, who, in effect, is as much a consultant as a banker," says attorney Mazer. After all, he observes, it is the lender, in the role of consultant as much as banker, who elicits information from the hospital to address FHA requirements. The process can be delayed if FHA must request additional information after a preapplication meeting. Because all of the information from the preapplication goes toward the full application, there should be no need for

CASE STUDY: THE VALUE OF FHA MORTGAGE INSURANCE

Project: Replace 40-year-old Gooding County Memorial Hospital, a critical access hospital

Cost: $27.6 million

Interest rate without credit enhancement: Estimate: 8 percent

Interest rate with FHA 242 mortgage insurance: High estimate: 6 percent (Actual pricing will likely be lower.)

First-year interest savings: $360,000

Twenty-five-year interest savings: $7.1 million

Source: Lancaster Pollard.

duplication of effort on the part of the hospital, and no reason not to provide as much information as possible at that early stage.

Every item in the FHA guidelines should be addressed in detail in the preapplication process, with the mindset that all of FHA's questions should be answered even before they've been asked. For example, it will be necessary to identify whether the hospital is in a CON state, to address management agreements, and to be able to attest to the architect's and construction company's level of experience in healthcare finance.

Also key to a successful financing is the attitude of the hospital toward the people who run the program, and responsiveness to any questions. FHA's estimate for full application approval does not count any down time spent waiting for responses to questions it asks of hospitals. Some hospitals might be tempted to view the government as the enemy, but they should keep in mind that the FHA's 242 program is intended to provide assistance, and HUD's current structure is actually designed to help hospitals. Hospitals, therefore, should understand that the questions HUD asks are, almost always, the types of legitimate questions that any insurer would ask.

The 242 mortgage insurance program is only one of the options in a toolbox of financing strategies hospitals should evaluate, but it's one that may be called upon more frequently in the current markets.

"We hadn't heard about 242 until it was brought up by our adviser," says Gooding County's Fitzpatrick. "In the volatile market as it stands now, federal backing is really what's moving the project forward at this point." ●

About the author

Alan J. Spidel
is vice president, Lancaster Pollard, Denver, a recipient of the HFMA Founders Follmer Bronze Award, and a member of HFMA's Colorado Chapter (aspidel@lancasterpollard.com).

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