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Health Care

by Alan J. Spidel

Hospital Mortgage Insurance: Section 2-4-Who?

Hospitals that need to borrow money in today’s tight credit market could find the financing solution they need in a 40-year-old federal program - one that has been seeking to increase awareness at the same time access to other financing options is decreasing.

The Federal Housing Administration’s Section 242 hospital mortgage insurance program works in much the same way as homeowner mortgage insurance: if the hospital defaults, the investor will still be paid because the government has backed the loan. With the full support of the government, the hospital borrower appears less risky, and will be able to attract investors at a lower interest rate.

The FHA is working to improve program awareness and efficiency. The addition of former hospital leadership to FHA staff, the streamlining of the application and improvement in processing times, and a national marketing campaign to increase program use coincide with a credit crunch that could have more hospitals of all sizes turning to the Section 242 financing option.

How It Works

The FHA Section 242 program generally is available to fund new facilities, acquisitions or substantial renovation. Hospitals may refinance debt through the program as long as at least 20 percent of the insured funding pays for new projects.

The program offers the opportunity

to issue taxable or tax-exempt bonds at an “AAA”-equivalent rating, and interest rates are fixed. The relatively long amortization of 25 years gives hospitals better opportunities to service their debt, and a high loan-to value ratio can minimize up-front cash requirements.

There is no limit to the amount of debt the Section 242 program will insure. It allows hospitals to borrow up to 90 percent of the project’s value. Project value calculations can include existing assets in addition to the actual project costs of new financing or construction, so if the entire project cost is 90 percent or less of the project value, then the 242 program can actually fund the entire project cost.

FHA-insured obligations are non-recourse to the borrower, which means parent organizations or systems are not liable for the debt of an individual facility. Subject to attainment of certain debt-service coverage and liquidity levels, hospitals utilizing the program may transfer excess cash flow to parent health systems or hospitals.

Program Eligibility

Section 242 mortgage insurance has insured 358 mortgages worth \$13.5 billion since 1968, with an average of five hospitals insured each year from 1995 to 2006. 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 ap-

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Section 242 Costs at a Glance

Issuing debt through the FHA 242 mortgage insurance program can save a considerable amount of money, but initial costs and the time necessary to apply for the program should be considered as part of the funding option analysis.

Fixed closing costs include:

- 0.30% FHA application fee
- 0.50% FHA inspection fee

Fixed transaction costs include:

- Davis-Bacon construction wages apply

Variable closing costs include:

- 2.00% to 5.50% for financing expenses (including mortgage bankers, investment bankers, attorneys and rating agencies), determined by the final transaction amount
- \$50,000 to \$125,000 for an examined financial forecast by a qualified accounting firm

Annual expenses (based on outstanding principal):

- 0.50% annual FHA mortgage insurance premium

The hospital must grant the 242 program lender a first mortgage on the entire hospital, including all real estate and improvements. (Exceptions may include leased equipment, off-site property, capital associated with affiliations, city and/or county owned facilities, etc.)

Application pipeline includes both a hospital with \$265 million in cash and a high 224 days cash on hand ratio, as well as several Critical Access Hospitals.

Applicants must:

- Principally be an acute care hospital that derives less than 50 percent of its revenues from chronic convalescence, drug and alcohol treatment, epileptic treatment, nervous and mental deficiency and tuberculosis treatment.
- Have positive average operating margins
- Have an average debt-service coverage ratio equal to or greater than 1.25 for the previous three years.

Critical Access Hospitals are entitled to special underwriting provisions that increase their chances of qualifying for the program. The 50 percent rule does not apply to them, and FHA streamlines the application process to speed up consideration. They still, however, must meet the operating margin and debt service coverage requirements. Hospitals that

only recently received their Critical Access designations are allowed under the program to calculate their historical pro forma debt service coverage ratio as if they had been receiving full cost-based Medicare reimbursement for the last three years.

What's New with 242

To increase awareness of the Section 242 program, FHA is focusing on attracting and educating new lenders (who must be FHA-approved to offer the program), working with state hospital associations to explain the program, exhibiting at hospital conferences, and advertising in health care magazines.

The program has benefited from several changes:

- It is shaking off its reputation for being a slow and cumbersome financial option, processing five of nine 2007 loans within its goal of 120 days, down from an average of 265 days in 2005.
- Former hospital CEOs and CFOs now evaluate loan applications. Their background knowledge allows them to jump directly to issues that matter to the application, rather than spending time learning about health care in general.
- As recently as 2000, 89 percent of the program's outstanding mortgage balances were in New York state. While 55 percent of the portfolio is still in New York, the program has expanded and insured mortgages in 42 states.
- FHA has increased program eligibility. It amended its policies to allow hospitals in non-Certificate of Need states to qualify, because most states have repealed the CON requirements that were in place when Section 242 was written.

Final Considerations

Key to a successful financing are the application's completeness, which is driven by the mortgage banker, and the willingness of the borrower to provide timely responses to FHA questions. The process can be delayed if FHA must request additional information following a pre-application meeting. As all of the information from the pre-application goes toward the full application, there is no duplication of effort on the part of the hospital, and no reason not to provide as much information as possible at that early stage.

The 242 program is only one of the options in a toolbox of financing strategies hospitals should evaluate, but given the current markets and recent program evolution, it is one that may be called upon more frequently.