Section II
Production

Chapter 3
Loan Sizing

3.1 Introduction

This chapter contains the loan sizing requirements for the Section 232 Mortgage Insurance for Residential Care Facilities program. Each loan program has different criteria for calculating the maximum insurable loan amount. The sections below describe which criteria to use for each program, and how to calculate each criterion. The maximum insurable loan amount is the lowest of all of the criteria rounded down to the nearest 100 dollars. The Maximum Insurable Loan Calculation (Form HUD-92264A-ORCF) (MILC) is a required Firm Application exhibit and is used to calculate the Maximum Insurable Loan.

3.2 Underwriting Benchmarks for Section 232 New Construction, 232 Substantial Rehabilitation and 232/223(f) Loans

Maximum Loan-to-Value Ratios (LTV) and minimum Debt Service Coverage Ratios (DSCR) are set by statutes and regulations. To mitigate risk, the following underwriting benchmarks have been established. Any submittals above the LTV or below the DSCR benchmarks require substantial justification and mitigation. Please note that the DSCR benchmark is calculated using the Mortgage Insurance Premium (MIP). To qualify for the higher Non-profit benchmarks, the Owner-Operator must demonstrate a successful operating track record, significant project operating and management experience, and a solid financial track record. The minimum debt service coverage ratio is 1.45 for all project types with the exception of the 223(a)(7) and Section 232(i) programs, which require a debt service coverage ratio of at least 1.11. Regardless of which underwriting benchmark is used, a Non-profit Borrower must establish a Residual Receipts account.

Type of Unit	New/Existing Units	Borrower Type	Max. Loan to Value*
SNF/ILU	Both	For Profit	80%
SNF/ILU	Both	Non-Profit	85%
ALF	New	For Profit	75%
ALF	New	Non-Profit	80%
ALF	Existing	For Profit	80%
ALF	Existing	Non-Profit	85%

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

3.3 HUD Eligible Costs

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

A. Eligible Mortgageable Costs

1. **Existing Indebtedness.** Section 3.13 describes eligible existing indebtedness requirements. (Eligible debt on Section 223(a)(7) transactions is addressed in Production, Section 2.10Q).

2. **Interest on Existing Debt.** Interest accrued on existing debt may be included in the determination of eligible debt.

3. **Prepayment Penalty.** The Lender must include the prepayment penalty that the Borrower is likely to incur at the time of closing, not at the time of the Lender's underwriting. This may include the yield maintenance fee.

4. **Interest Rate Premium (Section 223(a)(7) projects only).** The Lender may apply proceeds from an interest rate premium on behalf of the Borrower to defray prepayment penalties associated with the existing mortgage note. The amount needed to pay off the existing indebtedness for purposes of MILC Criterion H must not include any portion of the prepayment penalty that is being paid from an interest rate premium. Criterion H of the MILC will automatically deduct the amount of the interest rate premium disclosed on the S&U tab of the MILC. No portion of the interest rate premium will go to the Borrower or any of its affiliates. Any unused portion of the interest rate premium originally intended to defray prepayment penalties must be deposited into the Reserve for Replacement (R4R) account for future project needs.

5. **Initial Deposit to the R4R.** This amount is determined based on a R4R analysis completed by the Lender and reviewed by ORCF. These funds are deposited into the R4R account at closing.

6. **Existing R4R to Transfer.** On Section 232/223(a)(7) and 232/223(f)(/223(a)(7) projects, the existing R4R balance must be transferred to the new loan at closing.

7. **Estimate of Repair Cost (critical, non-critical and Borrower proposed).** The Lender's estimated repair costs to be incurred by the Borrower. Associated architect's fees, mechanical engineering fees, municipal inspection fees, and other similar fees may also be eligible. The Lender must provide evidence of these fees at the time of firm application and justify their eligibility. The contingency portion of the repair escrow agreement is not eligible.

8. **Appraisal (including updates).** Costs associated with completion of the Appraisal as part of the Firm Application submission. The Appraisal must be completed in compliance with the ORCF Appraisal Statement of Work (available on the Section 232 Program website).

9. **Phase 1 ESA / Environmental Review.** Costs associated with any third party reports required to comply with environmental review requirements.

10. **Project Capital Needs Assessment (PCNA).** Costs associated with completion of a PCNA for projects requiring a PCNA as part of the Firm Application submission. The PCNA must be completed in compliance with the ORCF PCNA Statements of Work for Section 232/223(f) and Section 232/223(a)(7) or 232/223(f)/223(a)(7) (available on the Section 232 Program website).

11. **Financial/Placement Fee.** The Lender's fee limit is based on a percentage of the loan amount. The below table shows the limits for each OHP Section 232 Loan Program. The Lender's legal fees are included in the fee limit. Yield maintenance fees are not included in the fee limits. See Section 3.14 for fee limits for bond transactions.

	Fee Limit
232 New Construction	3.50%
232 Substantial Rehabilitation	3.50%
241(a)	3.50%
232/223(f)	3.50%
232/223(a)(7) or 232/223(f)/223(a)(7)	2%
223(d)	3.50%
232(i)	3.50%

12. **Lender Legal.** Lender's legal costs associated with the insured loan transaction. These fees combined with the Financial/Placement Fee are subject to the fee limits in Section 3.14.

13. **Borrower Legal.** Borrower's legal costs associated with the insured loan transaction. Legal fees associated with zoning, land acquisition, environmental or other legal issues related to the land are not eligible for inclusion.

14. **Title & Recording.** The reasonable costs of obtaining a title insurance policy, title search and recording of closing documents. State or Local taxes associated with recording are also eligible for inclusion.

15. **Discounts.** Discounts paid by the Borrower for the FHA-insured loan.

16. **Bond Financing Costs.** Issuance costs associated with bond financing for the FHA-insured loan.

17. **Broker Fees.** Fees must be included in the Lender's fee limits listed in Section 3.14. The broker must have experience in healthcare finance transactions and must have no identity-of-interest with any of the participants other than the lender itself.

18. **HUD fees associated with the transaction.** These include the Application Fee, Inspection Fee (if applicable) and Initial Mortgage Insurance Premium (MIP). Production, Chapter 2 describes the HUD fees for each of the OHP Section 232 Loan Programs.

19. **Survey.** Costs related to the HUD-compliant survey associated with the insured loan.

20. **Additional Other Fees.** The Lender must provide justification at the firm application stage that other fees are reasonable and necessary for the development or refinance/purchase of the project. Examples include non-legal costs to create the borrower entity and costs of maintaining books, records and tax information for the Borrower.

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

1. **Land Purchase.** Purchase price of the site for the insured loan (subject to the constraints of 3.5.E.2 of this chapter). A purchase contract or other evidence of the transaction must be provided. If the site was subdivided at the time of purchase, this must be discussed in the Lender Narrative.

2. **Construction Contract Line Items.** These must be reflected on Construction Contract (Form HUD-92442-ORCF):
   a. **Land Improvements.** Earthwork, site utilities, roads and walks, site improvements, lawns and planting, and unusual site conditions.
   b. **Structures.**

c. **General Requirements.** Covers project-specific overhead expenses. Calculate as a percentage of the sum of Total Land Improvements and Total structures. Percentage amount is determined by the nature, difficulty and size of the project, and the characteristics of the neighborhood. The contractor shall provide a detailed cost breakdown of the items included in the general requirements.
d. **Builder's Overhead.** Covers contractor's head office and general business expenses. Amount is fixed at 2 percent of the sum of Total Land Improvements, Total Structures, and General Requirements.
e. **Builder's Profit.** Calculate as a percentage of the sum of Total Land Improvements, Total Structures, and General Requirements. Percentage amount is determined by the nature and location of the project.
f. **Bond Premium.** The bond premium covers Performance Bond. Used to ensure completion of construction in event of a default by the general contractor. Bonding company determines applicable rate by the nature and location of the project and the contractor's history. An irrevocable Letter of Credit may be used in lieu of a Performance Bond, provided it is unconditional, valid and collectable and issued by a banking institution.
g. **Contractor's Other Fees.** Costs of various required items and services. These can vary greatly from community to community. Examples of other fees include: building permits and licenses, builder's risk insurance, general contractor's cost certification audit fee, soil tests, concrete tests and other construction testing.

3. **Architect's Fees.** Architect's fees include both design and supervision costs. The architect's fees must match the Owner-Architect Agreement, AIA Form B108.
   a. **Design.** Architect's Design Fee covers preparation of all construction documents (working drawings and specifications) up to start of construction. Typically 75 to 80 percent of total.
   b. **Supervision.** Architect's Supervision Fee covers Architect's construction inspections, reports, and preparation of change order requests. Typically 20 to 25 percent of total.

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

C. **Interest Carrying Costs.** Interest on the amount of insured advances during the construction period of the project is allowable as part of Replacement Cost. The Lender must calculate the interest based on the proposed loan amount and interest rate over the proposed construction period. The final amount allowed will be reviewed at cost certification.

D. **Taxes.** Taxes associated with ownership of the property estimated on a per diem basis during the construction period.

E. **Insurance.** Insurance associated with the project estimated on a per diem basis during the construction period, including:

1. Builder's Risk Insurance (This must be part of the Contractor's General Requirements OR under insurance),
2. Liability Insurance,
3. Officer's and Director's Insurance,
4. Fidelity Bond Insurance,
5. Vehicle Insurance (For owner or operator vehicles associated with the project),
6. Business Interruption Insurance, and
7. Additional necessary insurance.

F. **Market Study (including updates).** Costs associated with completion of the Market Study as part of the Firm Application submission. The Market Study must be completed in compliance with the ORCF Market Analysis Statement of Work (available on the Section 232 Program website).

G. **A&E / Cost Reports.** Costs associated with the completion of the Third Party Architecture and Cost Reports. This includes the Geotechnical Report. The reports must be completed in compliance with the ORCF Architecture and Cost Statement of Work (available on the Section 232 Program website).

H. **Borrower's Cost Certification Audit Fee.** CPA Auditing Fee for the Cost Certification Audit. This does not include the cost to set up the books and records, or to file tax returns.

I. **Major Movable Equipment.** Large furniture and equipment with relatively fixed location, but capable of being moved. Examples include: wheeled equipment, office machines (e. g. computers, copiers, and fax machines), hospital beds and mattresses, tables, etc. Do not include any motorized vehicles, such as trucks, vans, automobiles, or golf carts. These are not mortgageable items. Do not include Minor Equipment and Supplies. Expendable non-realty items of small individual cost. Examples: china and flatware, utensils and instruments, linens, etc.

J. **Marketing.** Advertising, Salaries and Commissions of sales representatives, open houses, model units, and other reasonable and necessary expenses associated with marketing the project during the construction period. The Lender must assure that there are sufficient funds available for marketing.

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

L. **Contingency Reserve.** The contingency reserve amount is based on available data for the type and condition of structure. It is calculated as a percentage of the sum of structures, land improvements, and general requirements. Percentage ranges from 1% to 10%, depending on the condition of the project, extent of the rehabilitation, and experience and financial capacity of the borrower and contractor. The contingency reserve is only available for Substantial

Rehabilitation projects, and can only be used to cover unanticipated costs, such as discovering more extensive dry rot than was expected. The contingency reserve is not available for items such as an increase in cost of carpet. Subject to lender and HUD approval, the Borrower may elect to apply any funds remaining in the substantial rehabilitation construction contingency account after completion of the approved rehabilitation to:

1. further improvements, betterments or upgrades to the property,
2. an initial deposit to the Reserve for Replacement account; or
3. reducing the mortgage balance.

If excess funds from contingency are used for betterments, those additional improvements will not be considered as the basis for a request for an increased mortgage amount.

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

3.4 Section 232 New Construction

The Maximum Insurable Loan is the lesser of the following:

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

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Replacement Cost (Repl Cost) tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land improvements and the unpaid balance of special assessments.

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

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

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

1. Divide the underwritten Net Operating Income (NOI) by 1.45.

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

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

3.5 Section 232 Substantial Rehabilitation

The Maximum Insurable Loan is the lesser of the following:

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

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land improvements and the unpaid balance of special assessments.

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

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

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

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

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

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

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

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

3.6 RESERVED

3.7 Section 241(a) Supplemental Loan for an Existing FHA-Insured Project

The Maximum Insurable Loan is the lesser of the following:

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

B. **Amount Based on Replacement Cost (MILC Criterion C)**

1. Multiply the Total Estimated Replacement Cost as calculated on the Repl Cost tab of the MILC by 90%.
2. Subtract from the product any of the following: the optional purchase price of leased land, grant or loan funds attributable to replacement cost items, excess unusual land

improvements and the unpaid balance of special assessments.

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

1. Subtract the "as is" market value from the "as proposed" market value.
2. Multiply the difference by 90%.
3. Subtract from the product any of the following: the optional purchase price of leased land and the unpaid balance of special assessments.

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

1. Subtract the annual debt service (P&I+MIP) on the primary FHA-insured loan from the underwritten NOI after the renovations or additions proposed in the 241(a) loan application are complete.
2. Divide the difference by 1.45.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by Criterion E).
5. Add any annual tax abatement savings to the quotient.

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

1. Multiply the "as proposed" market value by 90%.
2. Subtract from the product 100% of the total outstanding indebtedness related to the property.

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

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

The Maximum Insurable Loan is the lesser of the following:

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

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

1. Multiply the appraised value by the maximum LTV limit.
2. Subtract from the product any of the following: the optional purchase price of leased

land and the unpaid balance of special assessments.
3. See Section 3.2 for maximum LTV limits.

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

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

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

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs any escrows or items the seller will pay on behalf of the Borrower, as well as any grants or loans attributable to HUD Eligible Costs.
3. Multiply the difference by 85% (90% for Non-profit Borrowers) of the purchase price shown in the purchase agreement and determined allowable by the Lender.
4. **Rules for Eligible Costs on Purchase Transactions.**
    a. The purchase price shown in the purchase agreement and determined allowable by the Lender. If the Borrower is currently the Operator of the project and does not have an identity of interest with the seller (see Handbook Introduction, Chapter 1.6 C), subtract from the purchase price the cost of any improvements that the Operator financed and the seller included in the purchase price.
    b. If repair costs are included in the purchase price, do not itemize them as separate HUD Eligible Costs.
    c. The purchase agreement must specify whether the transfer includes any:
        i. Escrows, and if so, the dollar amounts of those escrows.
        ii. Items which the seller will pay on behalf of the Borrower, such as the operating deficit, discounts, initial deposit to the R4R account, etc.

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

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as well as any grants or loans attributable to HUD Eligible Costs.
    a. Any collateral held against the loan by the commercial Lender, other than property-related assets, must be treated like R4R on deposit and subtracted from the Total HUD Eligible Costs. This includes any additional collateral held against the loan other than property related assets, including but not limited to, R4R, escrows, restricted bank accounts, debt service reserves and

completion reserves.

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

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

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

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

The Maximum Insurable Loan is the lesser of the following:

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

B. **Original Principal Amount (MILC Criterion B)**. This is the original principal amount of the existing FHA-insured mortgage.

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

1. Divide the Lender's underwritten Net Operating Income (NOI) by 1.11.
2. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
3. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
4. Add any annual tax abatement savings to the quotient.

D. **Amount Based on the Cost to Refinance (MILC Criterion H):**

1. Start with the Total HUD Eligible Costs as calculated on the S&U tab of the MILC.
2. Subtract from the Total HUD Eligible Costs the amount of any R4R on deposit, as well as any grants or loans attributable to HUD Eligible Costs. HUD Eligible Costs for a 223(a)(7) refinance transaction are limited to costs listed in Section 3.3.
3. Also subtract from Total HUD Eligible Costs any portion of the additional deposit to the R4R that is being paid from an interest rate premium.
4. 100% of the difference is the eligible loan amount.

3.10 Section 223(d) Operating Loss Loan

The Maximum Insurable Loan is the lesser of the following:

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

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

1. Subtract the annual debt service (P&I+MIP) on the primary FHA-insured loan from the underwritten NOI.
2. Divide the difference by 1.45.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
5. Add any annual tax abatement savings to the quotient.

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

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

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

3.11 Section 232(i) Fire Safety Equipment Loan

The Maximum Insurable Loan is the lesser of the following:

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

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

1. Subtract the annual debt service (P&I+MIP) on the primary loan from the

   underwritten NOI.
2. Divide the difference by 1.11.
3. Subtract from the quotient any of the following: the annual ground rent and the annual special assessment.
4. Divide the difference by the sum of the interest rate, MIP rate and initial curtail rate (as calculated by the MILC Criterion E).
5. Add any annual tax abatement savings to the quotient.

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

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

3.12 Tax Abatement

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

3.13 Existing Indebtedness

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

Existing indebtedness must meet the eligibility criteria outlined herein to be included as an eligible mortgageable cost for HUD Section 232 insured mortgages. HUD does not permit FHA-insured loan proceeds to be used directly for an equity takeout for Section 232 transactions. The following guidance applies to all Section 232 pursuant to 223(f) refinances and Section 232 Substantial Rehabilitation projects.

A. **Definition of Eligible Debt.** In order to be included as part of the Section 232 mortgage, existing indebtedness must meet the following FHA requirements. The debt:

   1. Must be existing indebtedness incurred in connection with the project,
   2. Must not have been created with an Identity of Interest (IOI) Borrower and the proposed FHA Lender, and

3. Must not otherwise circumvent program intent.

B. **Categories of Eligible Debt.** When demonstrating the eligibility of existing indebtedness, the FHA Lender must provide satisfactorily documented evidence that the existing debt incurred in connection with the project conforms to one of the categories below:

1. **Outstanding mortgage(s).** Outstanding mortgage(s) on the project as confirmed and fully documented by the current Lender.

2. **Other Recorded Indebtedness.** Other recorded indebtedness in connection with the project incurred by the Borrower pursuant to the normal course of business may be considered. Examples include, but are not limited to, mechanic's liens, tax liens and past due assessments provided they did not result from personal obligations of the Borrower principals. Note that operator agreements with the former owners that do not appear to be arm's length or with abnormally high lease cost arrangements need to be thoroughly analyzed.

3. **Unrecorded Debt.** Unrecorded debt of, or costs incurred in connection with the project and supported by documentation satisfactory to HUD may be considered eligible debt. The Lender must be provided with documentation and a certification that verifies the obligation is directly connected to the project. In instances where there are costs incurred, the documentation could include invoices, payment documentation, photographs, and a description of the work done. This includes indebtedness or costs incurred to make HUD eligible capital expenditures, structural repairs and betterments to the property.

4. **Operator Debt.** Certain Operator debt tied directly to the project, supported by documentation satisfactory to HUD and made by a related party with an IOI to the borrower, may be considered eligible. Examples include costs related to the purchase of additional furniture fixtures and equipment, working capital related to lease-up and stabilization of the project and other capital expenditures. Costs associated with an accounts receivable line of credit will not be considered eligible. Costs related to acquiring bed authority or Certificate of Need will not be considered eligible.

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

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

if:

a. The loan comprising the existing indebtedness meets eligible debt and debt seasoning requirements,
b. The release provisions for the funding of the current loan were predetermined at the time the original loan was made, and
c. The escrow is released before the FHA Lender makes application to HUD for mortgage insurance.

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

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

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

6. **Other Eligible Costs.** Examples of other eligible costs associated with paying off the eligible debt are:
   a. Reasonable, non-delinquent accrued interest to a non-IOI party,
   b. Provided they do not cumulatively exceed 10% of the proposed mortgage amount, prepayment/program penalties:
      i. on the mortgage loan and program penalties arising from the defeasance (or yield maintenance) of conventionally – financed loans,
      ii. arising from the defeasance of tax-exempt and taxable bonds, and/or
      iii. related to swaps or other derivatives, i.e., the costs of settling prepayment penalties or yield maintenance fees associated with swaps or other derivatives (e.g., swap breakage fees)
   c. Recording, release, and re-conveyance fees, and
   d. Documentation or processing fees.

C. **Debt Investigation.** Instances which trigger a debt investigation **-** HUD requires a debt investigation of the existing indebtedness when:

1. The creation of the debt involved a lender with an IOI to the borrower or project,

2. The current loan was created less than two years ago,

3. Circumstances are present that indicate the previous financing may have included other forms of non-standard collateral that suggest the debt was not created in an arms-length transaction,

4. The current loan involved alternate financing structures (e.g., pooled debt, line-of-credit financing, and mezzanine debt) and requires further explanation, as deemed necessary by HUD,

5. The current Lender held escrows or compensating balances that will be released back to the Borrower, or

6. Any other non-traditional debt or atypical obligations/interests/agreements are involved.

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

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

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

D. **Debt Seasoning**. Debt seasoning is a minimally required period of time between the closing date of a loan and the date that an application to refinance the existing debt is submitted to HUD. HUD uses the debt seasoning period to determine whether the project has demonstrated the ability to generate a sufficient level of cash flow to support the value and pay debt service (These provisions do not alter the requirements of 24 CFR Sec. 232.902 where otherwise applicable). If the existing debt to be refinanced does not meet the debt eligibility requirements defined in section 3.13.B, then 2 years debt seasoning is required. However, ORCF has identified specific exceptions to the full 2 years seasoning requirement as outlined in this section.

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

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

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

Reduced debt seasoning times are intended for certain low risk projects. Special Use Facilities, given ORCF's risk concerns about these types of facilities (see Chapter 2.5.E of this Handbook), are not eligible for reduced debt seasoning time, even if they meet the existing debt % and LTV parameters in above chart.

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

1. The documentation supports that the project is valued at fair market value,

2. The transaction must not include other forms of non-standard FHA collateral that suggest the project-related debt was inflated or included costs that overstated arms-length project debt, and

3. Evidence provided to support that the debt meets the debt seasoning requirements outlined above.

F. **Review of Recent Indebtedness Involving a Purchase.** If the outstanding debt was generated less than two years ago and involved a purchase, HUD will require a review of existing indebtedness.

1. **Identity of Interest (IOI) Purchase.** A transaction is considered to be an IOI purchase when there is any IOI (as defined in Section I, Introduction, Chapter 1.6) between the seller and purchaser that survives a sales transaction, or when a partner buys out the interest of another partner or member of the borrowing entity. Under these circumstances, the documented existing indebtedness used to effectuate such a transaction may be immediately eligible as provided below:
   a. The seller has no residual rights to control the project.
   b. The seller has no residual rights to reacquire the project until not less than five years of the HUD closing, otherwise the HUD loan will need to be paid off,
   c. The purchase must have occurred prior to the date on which the firm commitment was issued.

2. **Identity of Interest (IOI) Refinance.** A transaction is considered to be an IOI refinance when a portion of the debt to be refinanced with the FHA mortgage was created by a person or entity with an IOI to the borrower (e.g. partnership debt). Examples of this situation include transactions completed below market value due to

a pre-negotiated purchase price or a quick turnaround of a previously underperforming project. Existing indebtedness used to effectuate such a transaction may be eligible subject to the following:

a. A minimum of 12 months (under the new operator) demonstrated net operating income (NOI) that supports the requested mortgage amount,
b. For turnarounds, the operator must have a proven track record of successful turnarounds and maintaining operations. In support, the FHA Lender will provide in the Lender Narrative documentation from other similar project operations, including:
    i. Project name and address
    ii. For a time period (3 or more years) including before, during and after transition to the new operator:
        1. Revenue
        2. NOI
        3. Number of beds or residents or units
        4. Occupancy

Additionally, an ORCF appraisal review is required.

3. **Sale-leaseback transactions.** An Owner-Operator that sells its interest in a project, but continues to operate the project after the sale is generally considered an IOI purchase as outlined immediately above. If the selling entity continues to operate the project after the transaction, it will NOT be considered an IOI purchase when the following conditions are met:
    a. The transaction was completed at arms-length,
    b. The sales transaction was completed at market value (ORCF-approved full appraisal review),
    c. The operating lease is a typical market rate lease transaction between the old owner and the new owner,
    d. Documentation of organizational structures clearly indicates that there is no IOI between or among individuals actually involved on both sides of the transaction, and
    e. The seller has not taken back any note and has no residual rights to reacquire the project.

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

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

1. **Bridge Loans**. A bridge loan is a loan that is short term in nature that allows a Borrower to borrow short term funds to bridge a gap between the repayment of the previous loan or financing structure (or a purchase) and permanent financing such as an FHA-insured loan. Bridge loans are subject to requirements for debt seasoning, identity of interest between lenders and borrowers, and Debt Investigation as outlined in Section 3.13 A, Section 3.13 B, Section 3.13 C, Section 3.13 D and Section 3.13 E.
    a. The bridge loan itself does not need to season for two years if the amount of the bridge loan is equal to the outstanding principal amount of the previous loan, and there was no equity cash out to any individual or entity.
    b. As incentive for lower risk loans to seek FHA financing, two-year seasoning may not apply based on a combination of LTV and the portion of the bridge loan that consists of outstanding principal amount of a previous loan. If the bridge loan includes payoff of outstanding principal from an arms-length loan and/or other proceeds, then the full amount of the bridge loan is eligible for an FHA loan within two years as long as it meets the criteria in the above Section 3.13D.:

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

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

    Absent a partial release, HUD expects the FHA Lender to document the amount of the existing debt related to each project proposed for an FHA-insured mortgage, or to otherwise substantiate that all the subject projects are liable for all the outstanding notes that will be paid off with FHA-insured mortgage proceeds. For portfolio transactions, the Lender shall specify if any debt is non-project related and provide a reasonable allocation of total debt between non-project and project-related debt. For example, a large transaction may also include certain non-project subsidiaries such as rehabilitation firms, operating entities, hospices, corporate office buildings or other non-project facilities or entities. FHA Lenders must adhere to the following guidance for analyzing and investigating portfolio indebtedness if the partial release information is not available:
    a. The FHA Lender must perform Debt Investigation and submit to HUD documentation that substantially connects the proposed project to the outstanding indebtedness (See Section 3.13 F above).
    b. HUD expects eligible debt will be allocated (both individually and collectively) using one of the following methods which can be demonstrated

to bear a direct relationship to the existing indebtedness:

i. **Allocation of Debt**. An allocation of debt based on ORCF-compliant appraisals for all the projects covered by the existing debt is the preferred allocation method. To calculate, add up the approved values for all the projects and divide the total debt by the sum of the values. Multiply the result by a project's value to determine the amount of existing indebtedness to be assigned to a project.

ii. Lenders may develop other options for assigning debt, such as debt based on number of beds, number of units, percentage of revenue or percentage of overall NOI. However, all are subject to ORCF review, and approval will be considered on a case-by-case basis and appraisals must support the proposed value.

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

3. **Line-of-Credit Financing.** HUD will consider as eligible line-of-credit indebtedness attributable to HUD eligible acquisition costs, capital repairs and improvements. It is permissible for the line-of-credit financing to be initiated to reimburse the person or entity that financed the costs (e. g. reflect a loan made to the project to repay the parent corporation that purchased it with cash or another source of equity), so long as the reimbursed costs are traceable to the project and it meets the requirements for HUD eligible costs. All such transactions, must comply with the following:
    a. HUD will recognize line-of-credit portfolio indebtedness attributable to HUD eligible acquisition costs, capital repairs and improvements that are fully documented. If the project debt is currently pooled with debt from other properties, the FHA Lender must obtain a partial release of the portion of the indebtedness being brought in for an FHA-insured mortgage and demonstrate that the HUD eligible debt allocated to the project is fair and reasonable.
    b. Absent a stated release amount, the eligible debt amount will be determined following Section 3.13 G 2.
    c. When the line-of-credit indebtedness reflects reimbursed acquisition costs that exceed 15 percent of the purchase price, the Borrower must also submit a report from an independent CPA of the cash or equity payment incurred for the project. The report must be attached to a cover letter, signed and dated by an authorized officer of the borrower entity, which attests to the accuracy of the CPA's report, with the Section 1010 Criminal warning clearly set forth.

4. **REITs**. HUD has eliminated the Two-Year Look Back policy for REITs as previously described in the May 22, 2014 version of this Handbook. In a refinance pursuant to National Housing Act Section 223(f), all REITs are required to demonstrate debt such as through a line-of-credit financing (see above Section 3.13.G.3 for the requirements for line-of-credit financing).
    a. They will be required to demonstrate debt, such as through a line-of-credit that covers reimbursed acquisition costs, like other corporate entities and to apply as a refinance transaction.

5. **Mezzanine Debt.** Mezzanine debt is hybrid debt where one debt issue is subordinated to another debt issue. Typically, mezzanine debt is provided by a private lending source and can be secured by a pledge of partnership equity interests, a pledge of other assets and/or personal guarantees. The provisions limiting eligibility only apply when the debt is secured with a pledge of partnership equity interests. Mezzanine debt may have embedded equity instruments and profit sharing mechanisms included, which increase the net present value of the subordinated debt to the mezzanine holders. The existence and terms of all mezzanine debt must be fully disclosed and approved by HUD during the application process. Mezzanine debt will only be considered in the eligible basis for refinancing when:
    a. There is no IOI between the principals and the mezzanine Lender or any of its affiliates,
    b. The loan documents associated with the mezzanine financing clearly identify the debt as directly funding the costs of the property and of any HUD eligible improvements, and
    c. Any equity contributions made as part of the mezzanine financing are memorialized in a Note and reflected on a balance sheet as a liability.

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

3.14 Bond Financing

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

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

B. Loan Rates.

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

2. In many cases, the interest rate on the bonds will not be known during the commitment processing and it is not uncommon for the rate to change once the bonds have been sold and the bond interest rate has been established. If the interest rate changes, an amendment to the Firm Commitment must be requested by the Lender reflecting the actual interest rate. If due to time constraints, ORCF does not have sufficient time to reprocess a higher loan for the project:
    a. The Firm Commitment must contain the following condition:

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

    b. However, savings resulting from the early completion of construction must be reflected in interest cost in the Borrower's cost certification. Compute interest savings by:
        i. Recalculating the estimated interest line item on the MILC Replacement Cost Tab, using the actual interest rate for the scheduled construction period.
        ii. Subtracting the actual interest cost recognized at cost certification from the revised interest figure developed in (1) above.

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

C. Fee Limits:

Section 232 Loan Program	Bond Transaction Fee Limit
232 New Construction	5.50%
232 Substantial Rehabilitation	5.50%
241(a)	5.50%
232/223(f)	5.50%
232/223(a)(7) or 232/223(f)/223(a)(7)	4%

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

1. Any premium raised by a transaction is considered part of the Lender, bond underwriter, or issuer's profit. The one exception involves tax-exempt bond transactions where the issuer of the bonds may permit the Borrower to receive some portion of the premium to offset the cost of issuance so that the Lender, bond underwriter and issuer are simply conduits for the transfer of funds.

2. If any portion of the premium is returned to the Borrower, it will be treated as a Windfall for Section 232 new construction and Section 241(a) projects, reflected in the Windfall calculation for substantial rehabilitation projects, and transferred to the R4R account for Section 232/223(f) projects. Details on the Windfall calculation can be found in Production, Chapter 11.

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

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

1. The statement must explain why each individual item is necessary for the issuance of the obligations.

2. The Lender must review the amount of each item to ensure its reasonableness in relation to comparable projects.

3. The Lender, bond underwriter, and issuer have the option of deferring collection of additional discounts, financing fees slow draw fees, etc. in accordance with the provisions of the Lender Certification.

a. The deferred collection of these items must be an obligation of a third party. Both the third party and the Lender, bond underwriter or issuer must attest in writing that they will not look for payment from the:
   i. Borrower,
   ii. Mortgaged property,
   iii. Loan proceeds,
   iv. Any reserve or deposit required by ORCF and/or the Lender in connection with the insured loan transaction, or
   v. Rents or other income from the mortgaged property.

b. The borrower entity may issue, as evidence of the debt, surplus cash or residual receipts note to the third party for costs identified in this paragraph which ORCF determines to be reasonable.

F. State and Local Bond Financed Projects.

1. Prepayment of Note. Must include the following prepayment restrictions and prepayment penalty charges:
   a. Prepayment restriction period (lockout) must not exceed 10 years plus the construction period stated in the Construction Contract, or, in the alternative, must not exceed 10 years from the commencement of amortization, and
   b. Prepayment penalty may be charged after expiration of the lockout provided the charge:
      i. During the first year following the lockout does not exceed 5% of the original mortgage,
      ii. Declines on a graduated basis (to the extent practicable, the decline in the penalty percentage should be the same each year), and
      iii. Does not exceed 1% at the end of the fifth year following the lockout.

2. State/Local Occupancy, Use and/or Rent Restrictions. Use or rent restrictions sought by the State or local jurisdiction for projects financed by proceeds from State/local tax-exempt obligations are often more restrictive than the minimum requirements of the Internal Revenue Code. ORCF may approve a State or local restriction exceeding the minimum requirements of the Internal Revenue Code, but only if the following conditions are met:
   a. ORCF must determine that the restriction is not likely to have an adverse impact on project occupancy, marketability or long-term feasibility. This determination must be made on a project-by-project basis.
   b. The restriction must not conflict with any applicable ORCF mortgage insurance regulations or related administrative requirements.
   c. The restriction must not appear in the Note, Mortgage, Regulatory Agreement or any other ORCF mortgage insurance document.
   d. The restriction must be qualified to provide that it will automatically terminate in the event of foreclosure or transfer of title by deed in lieu of foreclosure. Such a termination provision must be included in every legal instrument (e.g., deed, land use restriction agreement, Security Agreement, or financing agreement) in which the restriction appears.

3.15 Secondary Financing

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

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

1. The secondary financing may be on a form of promissory note and secured by a mortgage lien as is prescribed by the governmental funding source and reviewed and approved by ORCF.

2. Secondary financing or grants lent to the property as a secondary loan may be used to cover up to 100% of the applicable Section of the Act equity requirements.

3. Secondary financing or grants lent to the property as a secondary loan may also be used to finance non-mortgageable costs, and when added to the FHA-insured loan and required equity contribution, may exceed 100% of the project's Fair Market Value (FMV) or Replacement Cost.

4. Non-mortgageable costs (i.e. replacement cost items, not eligible for inclusion in the FHA-insured loan) to be covered by governmental secondary loans, or grants lent to the property as a secondary loan, must be certified by the funding source to be reasonable and necessary to complete the project and that the project costs to be covered by the secondary financing are reasonable. Documentation to this effect must be included with the application submission.

5. The governmental secondary financing Lender must agree to and enter into a Subordination Agreement – Financing (HUD-92420-ORCF) that details the rights and legal relationship between the FHA-insured first mortgage and the secondary financing loan.

B. **When secondary financing is from a private source:**

1. **Section 232 New Construction and Substantial Rehabilitation.** Secondary financing from a private source is not permitted.

2. **Section 223(f).**
    a. The secondary financing must be evidenced by a promissory note conforming to the Surplus Cash Note (Form HUD-92223-ORCF). For Section 232 pursuant to 223(f) transactions involving Non-profit Borrowers use the Residual Receipts Note – Non Profit Mortgagor (Form HUD-91710-ORCF). This form must not be altered in any manner.
    b. The secondary financing is permitted to cover a portion of the equity requirement under Section 223(f). The aggregate amount of the FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. Therefore, the amount of a private loan may range from 7.5% of FMV (the

difference between 85% and 92.5% of FMV) to a larger percentage if loan criteria lower than 85% of FMV controls. Secondary financing from private sources are not permitted under other Sections of the Act. However, this allowance must not be used to circumvent existing policies which do not permit equity take-out on Section 232 refinance transactions or on purchase transactions, a way to finance costs that otherwise would not be permitted. For example, seller take backs on property acquisition costs that are not supportable by market data must not be approved.

c. When private secondary financing is combined with federal, state or local governmental agency secondary financing, the aggregate amount of FHA-insured first loan and the private second loan cannot exceed 92.5% of FMV. However the governmental loan, in aggregate with the FHA-insured first and private second, may exceed the property's FMV. The addition of the governmental loan may result in total liens that exceed the property's FMV.

d. Private secondary financing may be used to cover non-mortgageable costs in combination with equity or solely for one purpose or the other. Whatever option is decided upon, the aggregate of the FHA-insured first and private second cannot exceed 92.5% of FMV.

e. Non-mortgageable costs or non-HUD replacement cost items to be covered by secondary financing from private sources must be certified by the funding source to be reasonable and necessary to complete the project and that the project costs to be covered by the secondary financing are reasonable. Documentation to this effect must be included with the application submission.

f. **Mezzanine Financing.** Mezzanine financing is provided by a private lending source and is usually secured by a pledge of partnership interests rather than by a secondary lien on the real estate. The existence and terms of all mezzanine debt must be fully disclosed to and approved by HUD during the application process. Any remaining mezzanine debt of the property is considered private secondary financing, and is subject to the secondary financing guidance for private sources in this section. Repayment of mezzanine financing can only be made from surplus cash. It must be shown that the projected surplus cash may be reasonably expected to pay the interest due on the mezzanine loan. The mezzanine loan interest rate typically will be higher than the rate of the first mortgage, but must be reasonably consistent with market rates for mezzanine debt and must not be so high a rate that it jeopardizes the ownership stability of the property or that the interest due cannot reasonably be expected to be repaid from surplus cash. Interest due or accruing on the mezzanine loan must be approved as reasonable by ORCF.

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

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

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

1. The Lender on the insured mortgage must consent to the placing of the subordinate lien and agree that its existence does not constitute a basis for default on the first mortgage.

2. There must be a simultaneous closing and same day recordation of the subordinate financing documents and the first mortgage insurance documents.

3. The terms of the subordinate mortgage must be:
   a. Approved by the HUD Counsel;
   b. Consistent with the terms of the insured promissory note, the first mortgage, the Regulatory Agreement and all HUD Regulations and OHP Section 232 Program Requirements.
   c. The subordinate mortgage must not contain a cross default provision or any right of foreclosure before the termination of the FHA-insured mortgage.
   d. The term of the subordinate mortgage must be extended, if:
      i. The note matures, there are no surplus cash funds or residual receipts available for repayment and the first mortgage has not been repaid in full.
      ii. HUD grants a deferment of amortization or forbearance that result in an extended maturity of the insured mortgage.
   e. The subordinate mortgage must be assumable when a sale or transfer of physical assets occurs and the insured mortgage remains in place.
      i. The holder of the subordinate mortgage cannot require that more than 75 percent of the net proceeds of the sale or transfer be applied to the reduction of the loan.
      ii. For these instructions, net proceeds are the funds available to the original Borrower after correcting any monetary or covenant default on the first mortgage, making:
         1. Required contributions to any reserve fund, and
         2. Needed improvements to the property as evidenced by HUD's annual inspection reports.
   f. The subordinate mortgage must automatically terminate if HUD acquires title to the project by a deed in lieu of foreclosure.
   g. Only 75 percent of surplus cash can be pledged to the repayment of the subordinate loan(s).

E. **Accounts Receivable (AR) Financing.** AR financing is permitted provided that all of the requirements in Production, Chapter 15 are met, and ORCF has approved the terms of the AR financing.