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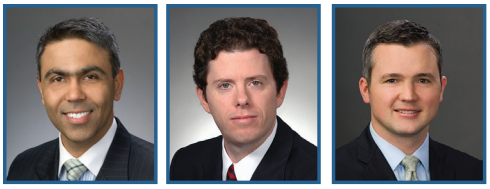

FHA-Insured Loans Reduce Rates Through Note Modification

When the nonprofit owners of a senior living facility in Nebraska looked to refinance their current loan insured by the U.S. Department of Housing and Urban Development (HUD)/Federal Housing Administration (FHA), they considered a little known program that has not been widely used in the past—note modification.

What is it?

One of the key benefits of FHA-insured financing is that it provides long-term debt at a reasonable cost on a nonrecourse basis and with few covenants. With the note modification program, FHA is trying to add to the list of benefits by accelerating the refinancing process. The agency can provide a faster turn-around by focusing on one loan parameter—the interest rate. Like any other government agency financing program, the key for the borrower will be to fit into the programmatic requirements.

A loan or note modification is the procedure through which the interest rate for existing HUD-insured loans is modified to take advantage of a low interest-rate environment. Because HUD has had unprecedented production volume in refinancing existing loans through both the Sec. 223(f) and Sec. 223(a)(7) programs, it realized that many borrowers were refinancing just to lower interest rates and were not seeking an extension of loan terms or additional loan proceeds. Consequently, HUD now is allowing applicants to lower interest rates via note modification on insured loans for health care, multifamily and senior housing. Although the program has many names within the industry, HUD has defined it as the Interest Rate Reduction (IRR) request.

Note modification is not a new process; HUD has allowed modification of existing loans for a long time. In the past, such requests were driven by the unique circumstances of a troubled project, such as difficulty in servicing debt or an impeding default. Note modification was then considered as a "workout" situation for defaulted loans.

However, due to historically low interest rates in combination with increased HUD volume, HUD has recently expanded the program by allowing borrowers in good standing to reduce the interest rate of current loans that have not been in financial or technical default within the past 24 months.

Should You Seek a Lower Rate?

Although there are some significant benefits to lowering interest rates through the IRR program, there are some items that the borrower must keep in mind before taking the plunge. One of those items is the lockout provisions and prepayment penalties associated with HUD loans. These provisions could dilute the benefits of lowering the rate for the borrower, who may have to consider paying the existing investor (or investors) a penalty to refinance

early. For some borrowers, modifying the note rate may be cost prohibitive as the prepayment penalties could erode the debt service savings. Moreover, the revision of the rate will put the facility into another lockout period with new provisions for prepayment. Finally, although small compared to a traditional FHA refinancing, the borrower may have to pay some out-of-pocket expenses. Most costs are eligible to be included in the revised interest rate, including: prepayment penalties, lender's financing fee, lender's counsel fee and title expenses. Other costs, such as the borrower's counsel fee, are not eligible and should not be too onerous but must be kept in mind.

A quick review of the existing loan could easily address the eligibility and costs associated with the loan modification. Compared to other options for lowering interest rates, such as a full-fledged refinancing of a loan, these costs are still a bargain. Other benefits include:

- The time it takes to modify the interest rate is much less than any other FHA program. The whole process could take less than six weeks from when a lender is engaged. It may be further reduced by working closely with the lender and HUD. This is significant when compared to Sec. 223(f) and Sec. 223(a)(7) programs. Considering the volatility in interest rates and impending decline in the Federal Reserve's bond buying program, this quick turnaround can reduce interest rate risk associated with longer processes.
- Another benefit of an IRR is that it does not require credit approval from HUD's production staff as these facilities are already in HUD's portfolio and are being monitored on a regular basis. HUD's asset management section is the only department that reviews IRR applications.
- The cost of refinancing is less than the cost of traditional refinancing programs because there are no third-party costs and legal fees are comparatively minimal.

Does Your Loan Qualify?

The IRR program could be a great alternative to the 223(a)(7) and 223(f) programs if your situation satisfies the following programmatic requirements:

- The current loan is insured by one of FHA's mortgage insurance programs.
- The interest rate is higher than current market levels.
- The facility's cash flow is sufficient and it has not been in default in the past 24 months.
- You do not wish to extend the loan term and do not seek additional loan proceeds. In other words, the final maturity and principal balance will remain unchanged.
- The current loan is out of the prepayment lockout period.
- All business agreements are in compliance.
- The debt service coverage ratio meets the applicable minimum requirements, 1.05 times for MAP or 1.11 times for LEAN.
- There are no outstanding issues in the management and occupancy reviews (MORs) and Real Estate Assessment Center's (REAC) physical inspection report.

Process

Once the decision has been made to modify the interest rate, it is important that borrowers contact their existing lender and discuss the opportunity. The lender will help the borrower determine if the facility has sufficient cash flow as HUD focuses on a trailing 12-month performance to measure it. If the cash-flow analysis is satisfactory, the lender will submit an application to modify the note. If HUD determines that the trailing 12-month financial performance is acceptable, the underwriting will be minimal. HUD will ensure that the amended note and title are clear as well as that the lockout provisions and prepayment penalties are included. HUD also will confirm that only eligible costs are included in the new rate.

Senior Living: Grace Pointe

Grace Pointe Assisted Living and Memory Care is a 63-unit facility in Lincoln, Neb. It is owned and operated by Tabitha Health Care Services (THCS), a Nebraska nonprofit organization. In 2011, Grace Pointe completed the construction of a new facility through the FHA Sec. 232 program. The interest rate on the original loan was 5.78% for a 40-year term. In September 2013, Grace Pointe came out of the prepayment lockout period and the loan was eligible for refinancing. The THCS board evaluated the pros and cons of the 223(a)(7) refinance program, but they decided to lower the interest rate through the IRR program for its quicker and less disruptive processing. The note rate was reduced from 5.78% to 4%, resulting in a net savings of $155,000 in annual debt service payments. To keep the rate low, the THCS board decided to use cash to pay for the cost of refinancing, including the prepayment penalty. Considering the board's long-term goal is to own and operate the facility for the foreseeable future, the transaction made a lot of sense. The annual debt service savings will offset all transaction costs within seven years.

Health Care: Jones Memorial

Jones Memorial Hospital (JMH), a 70-bed acute-care facility in Wellsville, N.Y., is an independent community hospital. Seeking to improve the hospital's liquidity and profitability, the JMH leadership team decided to take advantage of the low interest-rate environment to reduce the hospital's debt service expense.

JMH's indebtedness consisted of Series 1999 tax-exempt bonds, enhanced by FHA Sec. 242 mortgage insurance, which carried a 5.98% interest rate. The 242 IRR program allows a hospital to keep its existing mortgage insurance intact and avoid seeking credit reapproval from HUD's Office of Hospital Facilities. The JMH leadership team decided to take advantage of the program to refund its existing bonds with a mortgage loan. Given the relatively short remaining term of the indebtedness, the new loan priced lower than longer-dated FHA Sec. 242 transactions. JMH reduced its interest rate by more than half. The hospital's annual debt service savings were significant and enhanced the hospital's operational and financial flexibility, elements necessary to be a successful community hospital in today's uncertain health care environment.

Like any other refinancing, timing is important. Interest rates have increased from historic lows in 2012 and the first half of 2013, but are well below historical averages. Those FHA-insured borrowers who want a lower interest rate should consider the IRR program as they can lower their cost of capital without investing significant money or time. Short processing times and low transaction costs are not typically associated with FHA programs, but the IRR program has both.

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Hyperlinks:

Loan or note modification
http://portal.hud.gov/hudportal/documents/huddoc?id=IRrevguidance0713.pdf

Sec. 223(f) http://www.lancasterpollard.com/Uploads/Documents/TRM/232-223(f)_LEAN_Program_term_sheet.pdf

Sec. 223(a)(7) http://www.lancasterpollard.com/Uploads/Documents/TRM/FHA223(a)(7).pdf

IRR program http://portal.hud.gov/hudportal/documents/huddoc?id=IRrevguidance0713.pdf

Grace Pointe Assisted Living and Memory Care http://www.tabitha.org/living-communities/assisted-living/gracepointe

JMH http://www.jmhny.org/

refinancing
http://www.lancasterpollard.com/Plugins/AFS.LancasterPollard.Modules.RecentFinancings/Uploads/CS-HC-Jones-Memorial-Hospital.pdf