DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Parts 200 and 242

[Docket No. FR–4927–F–02]

RIN 2502–AI22

Revisions to the Hospital Mortgage Insurance Program

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner.

ACTION: Final rule.

SUMMARY: This final rule revises the regulations governing HUD's mortgage insurance program for hospitals. The rule updates and incorporates some earlier provisions that currently are not published as part of the Federal Housing Administration (FHA) regulations. Further, the rule adds new provisions to make them consistent with current industry practices. The rule also codifies the relevant regulations that address hospital mortgage insurance in one part, thereby making the regulations more user-friendly.

DATES: *Effective Date:* January 28, 2008.

FOR FURTHER INFORMATION CONTACT: Roger E. Miller, Director, Office of Insured Health Care Facilities, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 9224, Washington, DC 20410–8000; telephone (202) 708–0599 (this is not a toll-free number). Hearing- and speech-impaired persons may access this number through TTY by calling the Federal Information Relay Service at (800) 877–8339 (this is a toll-free number).

SUPPLEMENTARY INFORMATION:

I. The January 10, 2005, Proposed Rule

On January 10, 2005, HUD published a proposed rule intended to revise HUD's hospital mortgage insurance regulations. The proposed rule (70 FR 1750 *et seq.*) describes in detail the background and purpose of the hospital mortgage insurance regulation.

The January publication proposed eliminating references to hospital mortgage insurance in 24 CFR part 200, and proposed codifying the entire program in 24 CFR part 242. As a result, users of the regulation would be able to find everything they need in one location, and the rule would avoid unnecessary repetition.

The number of applications for hospital mortgage insurance has increased recently, and one purpose of this new rule is to respond to this increase with more detailed and complete regulatory guidance. The new details in the proposed regulation reflect HUD's actual experience with the hospital mortgage insurance industry, as well as statutory developments that have taken place in the last few years. The result is a new proposed comprehensive program of mortgage insurance for hospitals to replace the current, much less detailed regulations.

II. This Final Rule

This final rule follows publication of the January 10, 2005, proposed rule, and takes into consideration the public comments received. The public comment period for this proposed rule closed on March 11, 2005. HUD received comments from four commenters on a wide variety of issues related to the proposed rule. Commenters included a hospital industry trade association, a financing company, and two individuals. The final rule makes a number of changes to the proposed rule based on the comments received. The following pages present a short, section-by-section description of the changes HUD made in the final rule to clarify terminology, conform to a statutory change, and address public comments.

Section 242.1 Definitions

The final rule adds new definitions for the following terms: ''AMPO'' (Allowance for Making Project Operational); ''applicant''; ''construction''; ''days of cash on hand,'' in order to clarify terminology used in the definition of ''surplus cash''; ''most recent audited financial statement''; ''net income''; ''Secretary''; ''service area''; and ''substantial rehabilitation.''

The final rule deletes the definitions of ''Commissioner'' and ''working capital'' because they are no longer needed. ''Commissioner'' is not used in the final rule. ''Working capital'' has been replaced by the more commonly understood phrase, ''initial operating capital.''

The final rule clarifies terminology that was in the proposed rule. Commenters found the term ''credit instrument'' confusing, so this final rule uses the term ''mortgage note'' instead. For ''Debt service coverage ratio,'' the formula has been adjusted to include excess of revenues over expenses as an option for net income, and to take into account amortization expense. The definition of ''identity of interest'' has been revised to include examples in order to provide improved guidance. The term ''mortgagee'' has been clarified. The term ''operating revenue'' has been revised to state that, at HUD's discretion, additional items beyond those specifically mentioned, and that have been historically and reliably received, may be considered operating revenue for underwriting purposes. ''Preapplication meeting'' has been revised to clarify that the meeting includes HUD, the potential mortgagee, and the potential mortgagor. The definition of ''project'' has been clarified by using another defined term, ''substantial rehabilitation,'' and by specifying that construction may include replacement of an existing facility.

The definition of ''surplus cash'' has been clarified by defining the phrase ''days of cash on hand,'' which commenters found unclear, and by defining some terms used in the definition. In addition, instead of using the concept of cash earned, as proposed, the definition now considers surplus cash to be the cash remaining after certain conditions have been met.

Section 242.4 Eligible Hospitals: Transition Provisions

The final rule adds a new paragraph (b) to clarify when the regulations of part 242, as revised by this final rule become applicable, and revises the heading of this section to reflect the addition of transition provisions.

Section 242.13 Parents and Affiliates

The final rule clarifies that the purpose of assurances, guarantees, or collateral is to protect HUD's interests.

Section 242.15 Limitation on Refinancing of Existing Indebtedness

The final rule has substituted the word ''capital'' for ''long-term,'' because there may be instances where it is necessary to finance short-term debt.

Section 242.16 Applications

The final rule clarifies an exception to the 3-year positive operating margin requirement for hospitals in a turnaround situation. Under the exception, only one year is required to submit an application and 2 consecutive years of positive operating margin are required for application approval. The final rule replaces the word ''applicant'' with the words ''mortgagor or mortgagee'' in § 242.16(a)(4)(i) to reflect that both may expend resources in preparing an application.

Section 242.16(b)(6) is revised to take account of the fact that, as a commenter stated, complete architectural plans may not be available at this stage. In the final rule, architectural plans are to be filed with the application ''in sufficient detail to enable a reasonable estimate of cost.''

A reference to a 12-month timeframe for a decision on an application in § 242.16(f) has been removed in

response to a comment that the timeframe could imply that a 12-month wait for a decision is usual, and thereby discourage applicants. While HUD cannot promise a specific timeframe for its review, the agency endeavors to respond more promptly than 12 months.

Section 242.21 Refund of Fees

This section along with § 242.45(e) is revised to make clear that the portion of inspection fees paid for early commencement of work is not refundable.

Section 242.23 Maximum Mortgage Amounts and Cash Equity Requirements

Section 242.23(c) is revised to permit a private nonprofit or public mortgagor, at HUD's discretion and subject to 24 CFR 242.49, to provide equity in the form of a letter of credit. Also, the rule is revised to clarify that cash equity is in addition to property, plant, and equipment.

Section 242.24 Working Capital

The final rule clarifies that HUD did not intend to make an initial cash deposit a mandatory requirement. Whether such a deposit is required will depend in each case on the borrower's financial strength.

Section 242.26 Agreed Interest Rate

The final rule clarifies that different interest rates may be applicable to a project; for example, construction and permanent loan rates can differ.

Section 242.28 Allowable Costs for Consultants

Recognizing that hospital projects can have long planning times, this rule changes, from one year to 2 years, the time limit for allowing consultant's costs prior to the application.

Section 242.31 Accumulation of Accruals

The final rule is slightly revised to provide greater flexibility for mortgagors in purchasing fire and hazard insurance.

Section 242.33 Covenant for Malpractice, Fire, and Other Hazard Insurance

This final rule adopts language requiring the mortgagor to maintain adequate malpractice, fire, and hazard coverage acceptable to the mortgagee and HUD.

Section 242.35 Mortgage Lien Certifications

The final rule is revised so that, in exceptional cases, certain personalty may be excluded from the mortgaged property or the insured lender may take a secondary lien position on it.

Section 242.37 Mortgage Prepayment

The final rule permits the 30-day advance notice of intent to prepay the mortgage to be extended with HUD approval.

Section 242.39 Insurance Endorsement

Section 242.39(c) incorporates subpart B of 24 CFR part 207, covering contract rights and obligations of the mortgagor, mortgagee, and HUD, into this rule. The cross-reference in § 202.94 of the proposed rule is therefore no longer needed and is removed in this final rule.

Section 242.43 Application of Cost Savings

The proposed rule required that any cost savings be used to reduce the mortgage and the mortgagor's equity contribution proportionally. Under this final rule, the mortgagor can elect to have a greater proportion of the savings go to mortgage reduction.

Section 242.45 Early Commencement of Work

The final rule expands this provision to allow for early site preparation. It also provides that the cost of structures may be refinanced with insured mortgage proceeds if the work was completed more than 2 years before application. Where advance approval is sought for early site work and construction activity, HUD will require that key elements of an application be filed first, with the understanding that the remainder of the application will follow.

Section 242.49 Funds and Finances: Deposits and Letters of Credit

Section 242.49(a) is revised to give a fuller explanation of the mortgagor's deposit.

Section 242.50 Funds and Finances: Off-Site Utilities and Streets

For clarity, § 242.50 has been modified to specify that there must be adequate funds available to cover cost of off-site utilities and streets.

Section 242.51 Funds and Finances: Insured Advances and Assurance of Completion

This section is revised so that the amount of surety for completion is related to the construction contract (or Guaranteed Maximum Price, in the case of construction management) rather than the accepted bid price.

Section 242.53 Excluded Contractors

Section 242.53(c) has been revised in this final rule to provide for remedial and enforcement actions other than refusing to insure further advances.

Section 242.54 Nondiscrimination

HUD is revising § 242.54 in this final rule to clarify that the section does not affect the eligibility of women's and children's hospitals for this program.

Section 242.58 Books, Accounts, and Financial Statements

The final rule allows for the use of Governmental Accounting Standards in addition to Generally Accepted Accounting Principles because a number of hospitals use Government Accounting Standards.

Section 242.62 Releases of Lien

The final rule provides that HUD may set thresholds ''or other standards'' for the sale, disposition, transfer, or encumbrance of property securing a lien under this program.

Section 242.74 Smoke Detectors

This section is revised to provide that smoke detectors must comply with local law.

Section 242.76 Title Evidence

The final rule is revised to state that the title policy shall include as insureds not only HUD and the Secretary, but their successors and assigns.

Section 242.89 Supplemental Loans

This section has been revised to permit refinancing of debt incurred in connection with early commencement of work performed in accordance with the requirements of this rule.

III. Discussion of Public Comments on the January 10, 2005, Proposed Rule

The issues that commenters addressed were numerous. Therefore, this discussion organizes the comments into general comments and those addressed to specific sections of the proposed rule. The latter are organized by section order for convenience.

General Comments

Comment: The rule should be re-issued as an interim final rule and additional comments regarding ''any material concerns that remain after publication'' should be solicited. This is particularly important, since HUD policy tends to prohibit discussion about the rule after the close of the comment period.

Response: HUD believes that the public comment process provided sufficient opportunity for comment on the proposed rule.

Comment: The proposed rule was not adaptable and flexible enough for the hospital industry. This commenter stated that ''the Proposed Rule may inadvertently limit the application of a

longstanding and effective underwriting approach to Section 242 financing, which recognizes the organic and evolving nature of hospital delivery services.'' This is because hospital services are typically delivered in an ''evolving regulatory and service environment'' reflecting ''particular needs of a facility's service area as well as technological developments and revenue changes dictated by federal and state reimbursement rules.'' Adaptable underwriting standards will become more necessary as the program involves hospitals in new geographical areas. Absent needed flexibility, the ability of hospitals to participate in this needed program could be severely limited.

Response: HUD viewed the lack of explicit, published underwriting standards to be a weakness. A principal reason for publishing the proposed rule was to correct this weakness, so that potential participants can know in advance what HUD's basic underwriting standards are and to avoid wasting time and money on applications with little or no chance of being approved.

Comment: In order to make the program sufficiently flexible, HUD should move portions of the rule to informal program guidance. This non-regulatory, more flexible approach has worked well in other FHA programs.

Response: HUD views the program as being sufficiently flexible to accommodate a wide range of circumstances.

Comment: What is HUD's policy with regard to interest rate swaps?

Response: The mortgagor may not engage in interest rate swaps or other derivative-type transactions, except in conformance with policies and procedures to be established by HUD. HUD does not believe that the detailed policies and procedures need to be included in the rule. However, after consideration of this comment, HUD is adding clarifying language in the final rule at § 242.63, so that the section reads:

> The mortgagor shall not enter into any long-term debt, short-term debt (including receivables/line of credit financing), equipment leases, or derivative-type transactions, except in conformance with policies and procedures established by HUD.

Comment: ''Since loan to cost is based on the value of the mortgaged property I feel it is not applicable for periods beyond the date of closing. Distributions of equity if a concern should be a separate covenant if deemed a risk factor.''

Response: HUD assumes the commenter is referring to the definition of surplus cash, because of the reference to distributions of equity. Distributions of equity are controlled by §§ 242.65 and 242.66. There is a separate loan covenant in the loan documents based upon these sections.

Comments on Specific Sections

Revisions to Part 200

1. Section 200.24

Comment: One commenter stated that, as a practical matter, this section eliminates § 223(f) and part 242 refinancing for non-FHA insured loans, an unfortunate and unnecessary consequence. The rule should allow otherwise financially sound non-FHA hospitals access to much-needed debt service savings in a rapidly eroding low-interest rate climate when they have no present need for new capital improvements. This change would also allow FHA to realize additional fees and Mortgage Insurance Premium (MIP) revenues without related construction or start-up risk. This commenter stated that the application of Section 223(f) to FHA's multifamily programs has been determined to be sound enough to permit a program MIP reduction. A 223(f)/242 program would be equally successful.

A commenter stated that if the proposed deletion of Section 223(f) authority, which is currently in regulations, is adopted, and if at a subsequent date FHA determines Section 223(f) for hospitals to be in the public interest, FHA will face a difficult and time-consuming regulatory process to implement that result. This commenter states that there is no public policy benefit gained by deleting Section 223(f)/242 financing authority and that existing regulations should remain in effect.

Response: The reference to section 223(f) of the National Housing Act, 12 U.S.C. 1715n(f), in 24 CFR part 200, was never intended to provide program authority. Should the Department decide to implement section 223(f) for hospitals, explicit regulations would be required to provide program structure. HUD is not prepared to issue such regulations at this time, although it could consider doing so at a later date.

Comment: FHA's ''Operating Loss Loans'' authority has been deleted from the draft regulations. The commenter recommends that it be reinstated.

Response: With respect to Section 223(d), HUD's policy has been not to authorize any 223(d) loans for hospitals, and none have ever been authorized. The exclusion of Section 223(d) from the rule is consistent with that policy.

2. Section 200.40 HUD Fees

Comment: Section 223(f)/242 authority should be kept in effect by adding the following text from current regulations to § 200.40(c):

> For a mortgage being insured under Section 242 of the Act (12 U.S.C. 1715z–7), an application fee of $1.50 per thousand dollars of the amount loaned shall be paid to HUD at the time the hospital application is submitted to the Department and the balance thereof no later than initial endorsement.

Response: For the same reasons discussed in connection with comments regarding hospital loans under section 223(f) of the National Housing Act, HUD is not adopting this suggested change.

Subpart A—General Eligibility Requirements

3. Section 242.1 Definitions

Comment: The term ''applicant'' should be defined as to whether the term is meant to apply to the lender or mortgagor throughout the regulations. The ''applicant'' should be the mortgage lender.

Response: HUD agrees that ''applicant'' should be defined because of the possibility of confusion between the roles of lender and mortgagor. *Therefore, a definition of ''applicant'' has been added.*

Comment: The term ''application'' should be defined.

Response: HUD sees no need for a definition of this term; ''application'' is commonly understood in the industry.

Comment: The definition of cash should include operating cash, short-term investments, and funded depreciation accounts. By definition, this would exclude all trusteed accounts. Days of operating expenses should be defined as total operating expenses minus depreciation and interest.

Response: The comment appears to be a reference to the calculation of ''days of cash on hand,'' a term appearing in the definition of ''surplus cash.'' In order to clarify this term, a definition of ''days of cash on hand'' has been added as a separate definition.

Comment: The definition of ''chronic convalescent and rest'' should be revised to delete the terms ''respite care services,'' ''hospice services,'' and ''rehabilitation services.'' Instead, the definition of ''chronic convalescent and rest'' should be tied directly to the types of services provided in the Section 232 program. There is no evidence that the term ''chronic care'' set forth in the National Housing Act (NHA) includes respite care, hospice, or rehabilitation, particularly when delivered on an independent basis and not in

connection with chronic convalescent patients. The proposed definition would appear to exclude revenues received from these services from inclusion in the calculation of acute care patient days for purposes of determining whether a proposed project meets the NHA's 50 percent chronic care bed limitation.

Response: The inclusion of respite, hospice, and rehabilitation patient days in the definition of ''chronic convalescent and rest'' is consistent with the language in the introductory paragraph of the statute. That language would preclude patient days for such services from being counted for the purpose of calculating hospital eligibility based on patient days under the statute's ''50 percent rule.'' The statute, 12 U.S.C. 1715z–7(a), states:

> The purpose of this section is to assist the provision of urgently needed hospitals for the care and treatment of persons who are acutely ill or who otherwise require medical care and related services of the kind customarily furnished only (or most effectively) by hospitals.

Respite, hospice, and chronic rehabilitation services are not acute care services and do not require the services furnished only (or most effectively) by hospitals. Typically, these services are not provided in hospital beds, but rather in sub-acute settings. These services are most accurately included in the broad category, specified in the statute, of ''chronic convalescent and rest'' and, in some cases of rehabilitation, in the excluded categories of ''drug and alcoholic'' and ''mentally deficient.''

Comment: The rule should include a definition of ''commitment.''

Response: HUD sees no need for a definition; the concept of a HUD mortgage insurance commitment is well understood in the industry.

Comment: The rule should include a definition of ''credit instrument.''

Response: Where the term ''credit instrument'' appeared in the proposed rule, HUD has substituted the term ''mortgage note'' in this final rule for clarity.

Comment: A commenter stated that the definition of ''debt service coverage ratio'' should be revised to remove the second and third sentences, which reference a high coverage ratio. These sentences are unnecessary and potentially problematic. The proposed definition suggests that absent a ''high debt service coverage ratio,'' which is undefined, a project is ineligible. The language potentially conflicts with specific coverage standards set forth in § 242.16, and as such there would appear to be no need for a nonspecific policy statement of this type. At a minimum, a cross-reference should be made to § 242.16 to avoid interpretation conflicts.

This commenter also stated that the commenter presumes that the formula in the definition describes the formula currently in use.

Response: HUD agrees that the second and third sentences are potentially problematic and has removed them. The formula in the definition has been clarified, as follows: Debt Service Coverage Ratio (total debt service coverage on all long-term capital debt) equals:

$$\frac{(\text{Excess of revenues over expenses OR net income}) + \text{interest expense} + \text{depreciation expense} + \text{amortization expense}}{\text{Current portion of long-term debt [prior year, including capital leases]} + \text{interest expense}}$$

Comment: A commenter states that the rule should add a phrase to the definition of ''hospital'' to accommodate possible future changes, as follows:

> Hospital means a facility that has been proposed for approval or has been approved by HUD under the provisions of this subpart, as this definition may be modified from time to time pursuant to the Act. * * *

The commenter states that possible future changes may include, for example, an extension of the exclusion of Critical Access Hospitals from the 50 percent acute care requirement beyond its current 2006 sunset, or the elimination of the 50 percent rule in its entirety.

Response: The definition of ''hospital'' is statutory, as is the exclusion of critical access hospitals from the 50 percent rule. (See 12 U.S.C. 1715z–7(b)(1).) At the time of the comment period on the proposed rule, the statutory exemption for Critical Access Hospitals ended in 2006. On July 10, 2006, the exemption for Critical Access Hospitals was extended through July 31, 2011. The relevant portion of this final rule has been conformed to that statutory change. HUD does not believe further definition is necessary.

Comment: The definition of ''identity of interest'' should be modified as follows to permit identity of interest transactions subject to additional underwriting criteria, and to give HUD the ability to set the criteria:

> Identity of interest means a relationship that must be disclosed and may be either prohibited or subject to additional underwriting or criteria pursuant to the requirements of HUD or the Regulatory Agreement.

Response: HUD does not believe that this concept needs to be explicitly stated. HUD has the authority to waive provisions in the Regulatory Agreement for good cause. However, for clarity, HUD includes examples of identity of interest relationships in the definition in this final rule.

Comment: The definition of ''mortgagee or lender'' should be revised to remove material regarding trust indentures, and to expand the definition to include the ''proposed lender with respect to an application for commitment.'' Regarding the indenture, the commenter states that indentures, in the sense the industry uses the term, are not involved, and that the FHA mortgagor would not be a party to the indenture (the commenter states that ''indenture'' means a contract between a government bond issuer and a bond trustee for loans financed through tax-exempt revenue bonds). The suggested revised definition would read as follows:

> Mortgagee or Lender means the proposed lender with respect to an application for a commitment and/or the original lender under a mortgage, and its successors and assigns, which is the holder of the governing mortgage and other related credit instruments (All official contacts and actions by HUD shall be with or through a HUD-approved lender).

Response: The reference to ''trust indenture'' in the proposed rule derived from an obsolete reference. HUD does not insure trust indentures. Therefore, use of the term ''trust indenture'' would be confusing because many mortgages are funded with bond issues, pursuant to trust indentures. Therefore, this final rule changes the definition of ''mortgagee'' to:

> The original lender under a mortgage, and its successors and assigns, including the holders of mortgage notes issued under a trust mortgage or deed of trust, pursuant to which such holders act by and through a trustee therein named.

Comment: The first sentence of the proposed definition of ''mortgage reserve fund'' should be revised to read:

> Mortgage Reserve Fund means a trustee-held account for the benefit of the

Commissioner to which the mortgagor contributes funds required by HUD and from which withdrawals must be approved by HUD.

Response: The mortgage reserve fund is not only for the benefit of HUD, it is also for the benefit of the hospital to preserve the value of the hospital and to help prevent default. In order to clarify this purpose, the first sentence has been modified to state, ''Mortgage reserve fund means a trust account, or an account held by the mortgagee, for and on behalf of the mortgagor, to which the mortgagor contributes funds required by HUD and from which withdrawals must be approved by HUD.''

Comment: The second and third sentences of the definition of ''non-operating revenues and expenses'' should be revised, as follows:

Examples of items classified as non-operating are State and Federal income tax, general contributions, gains and losses from investments, and unrestricted income from non-designated endowment funds, and income from related entities received by a hospital sponsor. Classification of items as operating or non-operating shall be in accordance with generally accepted accounting principles or other applicable accounting standards.

Response: The suggestion is to insert ''non-designated'' before endowment funds to make the wording state that ''unrestricted income from non-designated endowment funds'' is excluded from operating income. HUD does not agree and would consider unrestricted income from all endowment funds to be non-operating revenue.

The commenter suggests that generally accepted accounting principles determine classification of operating and non-operating revenue and that investment income should be included in operating income. It is true that some endowment funds generate income for the general benefit of the hospital. However, the income these funds generate, depending on the type of investment and market conditions, are subject to variance and may not be available for servicing the mortgage in future periods. There is no direct corresponding expense associated with the investment income that can be eliminated if the investment income decreases. Therefore, this final rule retains the wording without change.

Comment: One commenter suggests a minor editorial revision to the definition of ''operating revenue'' under the heading of ''operating margin,'' to add the phrase ''but not limited to'' after ''including'' in the parenthetical example.

Response: HUD agrees that the items listed were intended to be examples and not an exclusive list.

Comment: The rule should add a definition of ''acute care patient days'' and provide for adjustment of ancillary non-bed hospital services to an acute care patient day.

Response: This term is not used in the rule and no definition is necessary. Also, HUD believes that the calculation of adjusted patient days is at a level of detail that is not necessary to include in the regulation.

Comment: A portion of the definition of ''personalty'' (from the third sentence beginning ''Generally, intangibles * * *'' to the end) should be revised, as follows:

Generally, intangibles shall also include all cash and cash escrow funds which are not otherwise pledged in connection with obligations of the mortgagor outstanding at initial endorsement, such as, but not limited to: depreciation reserve fund or mortgage reserve fund accounts, bank accounts, residual receipt accounts, all unrestricted contributions, donations, gifts, grants, bequests and endowment funds by donors, and all other revenues and accounts receivable from whatever source paid or payable. All personalty shall be securitized with appropriate UCC filings and any excluded personalty shall be indicated in the Regulatory Agreement and the Security Agreement.

The commenter states that the language regarding otherwise-pledged obligations should be added to provide an exception for funds pledged at or prior to initial endorsement in connection with bond-related obligations (such as construction fund negative arbitrage) issued to fund the FHA loan or in connection with other outstanding obligations of the mortgagor described in the FHA application. The qualifier of ''unrestricted'' should be added because under state law, donor restricted funds may be governed by terms and conditions set by the donor.

Response: HUD does not believe it is necessary to narrow the definition of ''personalty,'' because § 242.64 already permits exclusions for specific personalty.

Comment: One commenter suggests a minor clarification to the definition of ''preapplication meeting'' to specify that a potential applicant in this case is a mortgagor or lender, while elsewhere in the rule the term should refer to a mortgagee. The commenter suggests clarification of these usages.

Response: HUD has clarified the definition.

Comment: The definition of ''preliminary review letter'' should be revised, as follows:

Preliminary Review Letter means a letter from HUD to a potential mortgagee communicating the result of the Preliminary Review. The letter may: (1) State that an application for mortgage insurance would result in a rejection and provide the reasons for this determination, (2) state that there are factors that need to be further developed before a determination as to acceptability of a project for Preliminary Review may be made, or (3) state that no factors that would cause an application to be rejected have been identified, and therefore there appears to be no bar to the applicant proceeding to submit an application for insurance.

The commenter states that, even though an early determination of eligibility is desirable, the definition ''may be unnecessarily severe'' as proposed, and that the rule should provide for further discussion or the submission of additional materials at an early stage, which may present HUD with sufficient evidence to reverse an initial rejection. Also, the term ''next step'' is too vague and should be specified.

Response: HUD agrees that ''potential applicant'' in the first sentence should be replaced. HUD has replaced that term with ''proposed mortgagee or mortgagor.'' This language allows HUD to receive and fulfill requests for a preliminary review not only from proposed mortgagees, but also from proposed mortgagors (hospitals) that are seeking to determine if they are viable candidates for an insured loan, before they retain a mortgage lender.

HUD does not believe it necessary to insert the language the commenter proposes as clause (2), because communication often takes place between the mortgagee and HUD to clarify matters during the preliminary review and because there is already flexibility in § 242.16 for HUD to reconsider a negative determination.

HUD agrees that the phrase ''the next step in the application process'' is vague and has replaced it in this final rule with ''a preapplication meeting.''

Comment: The definition of ''project'' should be revised as follows to include the soft costs of construction (interest, taxes, MIP, etc.), as follows:

Project means the construction (which may include a replacement of an existing hospital facility), rehabilitation, modernization, expansion, or renovation of an eligible hospital, including equipment, which has been proposed for approval or has been approved by HUD under the provisions of this subpart, including the financing and refinancing of existing indebtedness and other related costs in connection therewith, if any, plus all related activities involved in completing the improvements to the property.

Response: In reviewing the definition of ''project,'' HUD realized that the word

was used to mean different things in different places. In several instances, the proposed rule used ''project'' when referring to the hospital or mortgagor. This usage derives from HUD's multifamily housing programs, in which ''project'' is used to refer not only to the construction project and the financing thereof, but also to the ongoing operations of the residential rental business during the life of the loan. For clarity, this final rule makes a distinction between ''project'' as defined here and ''hospital'' or ''mortgagor.''

HUD also considered the use of terms such as ''modernization,'' ''renovation,'' and ''expansion.'' The final rule uses the term ''substantial rehabilitation'' to encompass all of these activities, and a definition of this term has been added in § 242.1.

Finally, HUD believes that the definition of ''project'' is not the appropriate place to introduce the concept that a construction project includes soft costs.

Therefore, the definition of ''project'' has been revised to specify the meaning of the word in all contexts in which it is used in the rule, and to conform the definition to the final rule's definition of ''substantial rehabilitation.''

Comment: The definition of ''regulatory agreement'' should be modified to include lessees of the mortgagor, if applicable, as regulated entities under the regulatory agreement. The commenter cites the Shoshone Medical Center as an example.

Response: HUD disagrees. As a general policy, leasing of the entire hospital is not contemplated. However, HUD does have the authority to approve leasing, on a case-by-case basis, for good cause, as was demonstrated in the example offered.

Comment: One commenter suggests revisions as follows to the proposed definition of ''security instrument'' and also questions whether the definition is required, given that there is also a proposed definition of ''mortgage.''

> Security instrument means a mortgage, deed of trust or any other document evidencing security for the indebtedness represented by a note endorsed for insurance by HUD and shall be deemed to be the mortgage as defined by the National Housing Act, as amended, implementing regulations, and HUD directives.

Response: HUD believes that the definition of ''security instrument'' is adequate, and that it is inappropriate to include discussion of the note in this definition.

Comment: A commenter asked whether the rule could provide a definition of what constitutes the service area, and stated that some hospitals serve patients from all over the country or all over the state, although most of their patients come from the nearby surrounding community.

Response: In order to avoid ambiguity, a definition of ''service area'' is added to § 242.1 of this final rule.

Comment: The definition of ''state'' should be revised to change ''Virgin Islands'' to ''United States Virgin Islands.''

Response: HUD agrees, and this final rule adopts this change.

Comment: The definition of ''surplus cash'' is a departure from existing practice, particularly when proprietary sponsors are involved, in that it would no longer permit distributions of cash earned in prior periods that a mortgagor elected not to distribute. To eliminate this problem, surplus cash would be better defined in terms of cash remaining as opposed to cash earned in a fiscal period. This change would be in accordance with HUD Circular 4615.2 and HUD's draft applicant's guide. In addition, the commenter suggests changes to give HUD more flexibility to set standards. The commenter also proposes enlarging the ''days in accounts receivable'' portion of the test because, historically, many hospitals are unable to meet the proposed test. Accordingly, this commenter suggests the following revised language:

> Surplus Cash means any cash in the applicable fiscal period or prior fiscal periods, including accounts receivable, remaining after the following have been achieved:
>
> (1) Mortgage payments for the preceding 12 months have been made when due, including any grace period;
>
> (2) There is a Debt Service Coverage Ratio greater than or equal to 1.50 or such other ratio as HUD may deem appropriate;
>
> (3) Days in Accounts Receivable are less than or equal to 100 or such other day count as HUD may deem appropriate;
>
> (4) Days in Accounts Payable are less than or equal to 120 or such other day count as HUD may deem appropriate;
>
> (5) The Mortgage Reserve Fund is compliant with the scheduled balance;
>
> (6) All income, property, and statutory employer payroll taxes and employee payroll withholding contributions have been deposited as required;
>
> (7) The Current Ratio is greater than or equal to 1.50 or such other ratio as HUD may deem appropriate;
>
> (8) Days of cash on hand are greater than or equal to 15 days or such other day count as HUD may deem appropriate; and
>
> (9) The payment of:
>
> (i) All sums due or currently required to be paid under the terms of the Mortgage Note and Regulatory Agreement due on the first day of the month following the end of the applicable fiscal period, including, without limitation, in the Mortgage Reserve Fund or any other reserves as may be required by HUD; and
>
> (ii) All other current obligations of the hospital (accounts payable except for a 100 day exception and accrued, unescrowed expenses), unless funds for payment are set aside or HUD has approved deferment of payment.

Response: The addition of the qualifiers, ''or as HUD shall deem appropriate,'' negates the intended purpose of this rule to make clear the minimum financial standards applicable to hospitals with insured loans. With respect to ''surplus cash,'' HUD agrees that cash earned in prior periods that a mortgagor elected not to distribute would be included and that ''surplus cash'' should be defined as earned cash remaining as opposed to cash earned in a fiscal period.

This final rule also adds language to the definition requiring the hospital to meet particular minimum equity requirements and restricting distributions until those requirements are met. The final rule clarifies that the most recent audit required under the regulatory agreement, in conjunction with the effect of the distribution on the interim financial statements, will provide the basis for limitations on distributions. Items 9(i) and 9(ii) of the proposed definition were deleted as being duplicative. Accordingly, the final rule revises the definition of ''surplus cash.''

Comment: One commenter stated: ''We feel that 21 and 15 are very low standards. We would suggest it be raised to 30 days.''

Response: HUD assumes that this comment is meant to refer to the 15 days of cash on hand portion of the definition of ''surplus cash'' in the proposed rule. HUD agrees that 15 days cash on hand is a very low standard and has increased it to 21 days cash on hand. HUD considered the commenter's suggestion to increase the days of cash on hand to 30. However, HUD did not believe it necessary to raise the standard that high. The increase to 21 days strengthens the prior standard, provides sufficient liquidity to make a payroll, and is currently met by 50 percent of the hospitals in the HUD portfolio.

Comment: One commenter stated that ''average payment period'' would be a better measure to use in this definition.

Response: HUD assumes that the commenter was referring to the use of the term ''days in accounts payable'' in the definition of ''surplus cash.'' The measure ''average payment period'' has become the standard in the industry because it is more comprehensive and less subject to manipulation. HUD

agrees to the substitution of this measure for ''days in accounts payable.''

Comment: One commenter suggests that the definition of ''working capital'' be deleted because it is used only once in the rule (§ 242.24).

Response: HUD agrees with the comment. This final rule removes the definition of ''working capital'' in favor of a phrase that is better understood, ''initial operating capital,'' and revises the title of § 242.24 to ''Initial Operating Costs.''

4. Section 242.3 Encouragement of Certain Programs

Comment: One commenter states that everything after the word ''hospitalization'' should be deleted because the language ''is neither an eligibility requirement of the Act.* * *nor, to our knowledge, a statement of current FHA policy.'' The commenter is concerned that this language may be interpreted as a mandatory underwriting requirement, making otherwise eligible projects ineligible.

Response: The language that the commenter requests be deleted is indeed a requirement stated in the statute, 12 U.S.C. 1715z–7(f). This section states that:

> The activities and functions provided for in this section shall be carried out by the agencies involved so as to encourage programs that undertake responsibility to provide comprehensive health care, including outpatient and preventive care, as well as hospitalization, to a defined population, and, in the case of public hospitals, to encourage programs that are undertaken to provide essential health care services to all residents of a community regardless of ability to pay.

HUD's underwriting reflected this requirement in the past and will continue to do so in the future. HUD included the words ''and certain not-for-profit hospitals'' after ''in the case of public'' in recognition of the role that many not-for-profit hospitals fulfill in providing indigent care in areas where there are no public hospitals or in which public hospital capacity is limited. In response to the commenter's concern about mandatory underwriting requirements, HUD notes that encouragement of the provision of comprehensive health care to a population does not mean that a hospital is ineligible because it does not plan to provide comprehensive care or does not plan to provide services to all residents regardless of ability to pay. It does mean, however, that HUD should consider the provision of care and the role that a proposed hospital would play across the service area.

5. Sections 242.4 and 242.5 Eligible Hospitals and Eligible Mortgagees

Comment: Section 242.4 should be revised to conform to the definition of ''project'' by adding the phrase ''modernization, expansion, or renovation'' before the phrase, ''of an existing hospital.''

Response: The definition of ''project'' has been revised in response to other public comments to mean the ''construction or substantial rehabilitation'' of an eligible hospital. This change also addresses the issue cited by this commenter. In addition, HUD has added a paragraph on transition to these regulations.

Comment: The title to § 242.5 should be revised to read ''Eligible mortgagees/lenders.''

Response: HUD agrees, since this title reflects the terminology used in the final rule.

6. Section 242.7 Maximum Mortgage Amounts

Comment: The following phrase should be added after the word ''installed'' and before the period at the end of the sentence:

> * * *and other related project development costs, including but not limited to capitalized interest and Commissioner approved fees.

Response: HUD intended this section to outline broadly the maximum mortgage amount as a percentage of replacement cost. The level of detail sought by the commenter is outside the scope of this section.

7. Section 242.9 Physician Ownership

Comment: The last sentence of this section, as proposed, would require an ''unqualified legal opinion'' regarding compliance with applicable federal law. An unqualified legal opinion is difficult to obtain, and ''an opinion satisfactory to HUD'' would be a more appropriate standard.

Response: HUD has been able to obtain unqualified legal opinions on all professionally owned hospitals since the decision to accept these sponsors into the program was made in January 2003. It would take an inordinate amount of time and expertise for staff to perform the due diligence reflected in an unqualified opinion. The unqualified opinion benefits mortgagors that otherwise would have to obtain an opinion from the Inspector General at the Department of Health and Human Services (HHS). Therefore, in the best interests of the program, HUD shall retain the requirement of an ''unqualified legal opinion.''

8. Section 242.10 Eligible Mortgagors

Comment: Lessees of mortgagors should also be included for the same reason as in the definition of ''regulatory agreement.'' The commenter also states that the section should be revised to read in its entirety:

> The mortgagor shall be a public mortgagor (*e.g.*, an owner of a public facility), a private nonprofit corporation or association, or a profit-motivated mortgagor meeting the definition of ''hospital'' in § 242.1. The mortgagor or a lessee of the mortgagor shall be approved by HUD and shall possess the powers necessary and incidental to operating a hospital. Eligible proprietary or profit-motivated mortgagors may include for-profit corporations, limited partnerships, and limited liability corporations and companies.

The commenter states that ''natural persons, joint ventures and general partnerships'' are eligible mortgagors in other FHA insurance programs and is unaware of any program or legal basis for excluding such ownership forms from Section 242 eligibility if underwriting criteria are otherwise met. The sentence beginning ''for new organizations'' should be deleted and ''treated as a program, not a regulatory requirement.'' Finally, it would also seem inappropriate that stockholders of a privately held corporation should be required to admit other parties to its board of directors (although it may be considered for advisory board purposes), or to otherwise require that private corporations be treated as public entities. The term ''broad community participation'' is undefined, may be difficult to precisely define, and should be treated in a ''more flexible, case by case non-regulatory fashion.''

Response: Generally, this section states the statutory requirements for an eligible hospital mortgagor. Regarding the statement that lessees of mortgagors should also be included, the National Housing Act makes it clear that HUD can insure mortgages where long-term ground leases are involved. However, HUD generally prohibits leases of the entire hospital. In those rare instances where a lease is necessitated by local law, HUD will continue to evaluate each situation on a case-by-case basis.

The comments also suggest striking the latter portion of the section. This wording was carefully developed and HUD believes that there is considerable wisdom in not permitting mortgagor entities with other obligations that could interfere with the operation and stability of the hospital. The same is true of ensuring the continuity of the mortgagor entity so that a legal entity is in place for as long as HUD insures a mortgage loan. Finally, HUD does not agree that the language in this section

requires that private corporations be treated as public entities.

9. Section 242.11 Regulatory Compliance Required

Comment: One commenter suggests minor editorial changes, as follows:

An application for insurance of a mortgage under this part shall be considered only in connection with a hospital that is in substantial compliance with regulations of the Department of Health and Human Services and the applicable State governing the operation and reimbursement of hospitals. A hospital that is under investigation by any State or Federal agency for statutory or regulatory violations is not eligible so long as the investigation is unresolved, unless HUD determines that the investigation is minor in nature, that is, the investigation is unlikely to result in substantial liabilities or of otherwise substantially harming the creditworthiness of the hospital.

Response: HUD adopts these minor clarifying changes to the final rule. Noncompliance with HHS and state regulations can result in significant liabilities and can increase the risk of suspension or cutoff of reimbursements from federal or state payors, significantly increasing the risk that the hospital will default on the FHA-insured mortgage loan.

10. Section 242.13 Parents and Affiliates

Comment: One commenter suggests editorial revisions, as follows:

As a condition of issuing a commitment, HUD may require corporate parents, affiliates, or principals of the proposed mortgagor to provide assurances, guarantees, or collateral with respect to the mortgage loan. HUD may also require financial and operational information on the parent, other businesses owned by the parent, or affiliates of the proposed mortgagor and may also require a parent or affiliate to agree that it will not take any actions which could impact the financial viability of the hospital and its ability to repay the mortgage loan.

Response: HUD agrees that more language is needed to clarify the first sentence ending in ''collateral.'' However, the suggested language is too narrow. In the final rule, the sentence is revised to read, ''As a condition of issuing a commitment, HUD may require corporate parents, affiliates, or principals of the proposed mortgagor to provide assurances, guarantees, or collateral to protect HUD's interests.'' HUD interprets the second suggested revision also as narrowing HUD's ability to protect its interests. Thus, the existing language in the second sentence will be kept.

11. Section 242.14 Mortgage Reserve Fund

Comment: One commenter suggests editorial revisions, as follows:

As a condition of issuing a commitment, HUD may require establishment of a Mortgage Reserve Fund (MRF), a trustee-held account to which the mortgagor will contribute and from which withdrawals must be approved by HUD. The mortgagor shall be required to make contributions to the MRF such that, with fund earnings, the MRF will build to one year of debt service at five years following commencement of amortization, increasing thereafter to two years of debt service on and after ten years following commencement of amortization according to a schedule established by HUD, unless HUD determines that a different schedule of contributions is appropriate based on the mortgagor's risk profile, reimbursement structure, or other characteristics. In particular, hospitals that receive cost-based reimbursement may be required to have MRFs that build to more than two years of debt service. Expenditures from the fund may be made for such purposes, including the payment of debt service as HUD may determine or in accordance with the mortgagor's MRF Schedule. Upon termination of insurance, the balance of the MRF shall be returned to the mortgagor provided that all obligations to HUD have been met.

Response: The benefit of the MRF has been tested over time, and its availability has afforded hospitals in financial distress the time and relief needed to effectuate a turnaround. For that reason, HUD disagrees with the suggested substitution of the word ''shall'' with ''may.'' The availability of an MRF has served HUD, the mortgagee, and the mortgagor well, and this final rule continues to require it.

With respect to expenditures from the fund, HUD believes that the original language is clear on its face and that the additional wording is likely to result in confusion and misinterpretation as to the primary intent of the MRF, which is for the payment of debt service.

HUD concurs that the inclusion of ''following commencement of amortization'' clarifies the MRF funding requirement and has made the appropriate change.

Also, the final rule removes the text in the first sentence following the second comma, because the revised definition of ''mortgage reserve fund'' makes this language redundant.

12. Section 242.15 Limitation on Refinancing of Existing Indebtedness

Comment: One commenter states that the restriction to long-term debt should be removed and that 15 percent rather than 20 percent of the mortgage must be used for hard costs. As to the former suggestion, the change is necessary to permit loans to fund projects completed prior to initial endorsement and financed on the basis of short-term rather than long-term loans. As to the latter, the 20 percent requirement is not a statutory requirement, and the lower standard will allow ''otherwise necessary'' projects to be able to utilize the program. The revised language would read as follows:

Some existing debt may be refinanced with the proceeds of a section 242 insured loan; however, at least 15 percent of the amount of the mortgage must be used to fund the hard costs of construction, equipment and mortgageable costs and expenses related thereto, including but not limited to interest, taxes and other Commissioner approved fees typically included in a commitment.

Response: By deleting but not replacing ''long-term,'' the proposed revision would permit any existing debt to be refinanced, such as operating debt. This would be contrary to the intended purpose of the program to insure the financing of capital projects. However, HUD understands that there may be cases where it would be appropriate to refinance some short-term capital debt. Therefore, HUD has substituted the word ''capital'' for ''long-term.'' Reducing the 20 percent requirement to 15 percent would blur the distinction between Section 242 and Section 223(f), which HUD is not implementing for hospitals through this rule, and HUD does not agree to this revision.

Subpart B—Application Procedures and Commitments

1. Section 242.16 Applications

Comment: One commenter asks whether HUD determines the need or the state CON (Certificate of Need) process does, and states that the rule should clarify this issue.

Response: HUD conducts the same analysis of need whether or not the state has a CON process. There is wide variation in the methods CON states use to decide whether or not to issue a certificate. HUD believes that the Act's required need assessment is best performed using a method that is applied consistently to hospitals in all states. Should the state's CON process and HUD's assessment of need reach differing conclusions on the need for a proposed project, HUD will review the case closely to determine if its conclusion should be changed.

Comment: One commenter suggests a variety of substantive and editorial changes to this section. The commenter would revise § 242.16(a)(1), as follows:

(a) The process for approval of an application shall include consideration of the following financial and programmatic factors.

(1) Market need. The approval process shall include an analysis of the market need of the proposed project, on a market-wide basis, the impact of the proposed facility on, and its relationship to, other health care facilities and services; the number and percentage of any excess beds; and demographic projections.

Generally, except in cases acceptable to HUD, Section 242 insurance may support start-up hospitals or major expansions of existing hospitals only if existing hospital capacity or services are not adequate to meet the needs of the population in the service area.

(i) If the State has an official procedure for analyzing need for hospitals, HUD shall require that such procedure be followed before the application for insurance is submitted, and that the application shall document that need has also been established under that procedure; provided that in circumstances acceptable to HUD, an application may be submitted and review commenced prior to the issuance of such State approval.

Response: The commenter suggests deletion of the requirement that HUD consider the impact of the proposed facility on other health care facilities that ''have a disproportionate share of Medicaid and uninsured patients,'' because it is not a program requirement.

However, the statute, 12 U.S.C. 1715z–7, requires HUD to administer the program ''so as to encourage programs that undertake responsibility to provide comprehensive health care including outpatient and preventive care, as well as hospitalization, to a defined population. * * * Disproportionate share hospitals are a critical element in providing such care, acting as a ''safety net'' for care of the uninsured. These hospitals typically use profitable product lines to subsidize unprofitable activities in a practice known as ''cost shifting.'' A new project that takes profitable business away from a disproportionate share hospital can have the effect of reducing its ability to provide comprehensive health care to the local population. For this reason, HUD believes that it should pay particular attention to the impact of a proposed project on disproportionate share hospitals. Also, see HUD's response to comments on § 242.3.

The commenter also stated that ''in circumstances acceptable to HUD'' the rule should allow for an application to be submitted prior to issuance of official state approval. The commenter stated that as the program gets broader national application, there will be instances where it is ''prudent and equitable'' to begin the review of an application before a certificate of need is issued, ''particularly when it is reasonably inferred that a certificate of need will eventually be issued and the mortgagor is willing to pay the required application fee to reimburse FHA's costs.'' The commenter stated that this concern is ''particularly important in the context of the extensive construction periods associated with hospital projects, as well as the impact of escalating costs on project feasibility.''

However, HUD interprets the statute, 12 U.S.C. 1715z–7, to require that the certificate of need will be submitted as part of the application.

Comment: One commenter stated that § 242.16(a)(2) should be revised, as indicated:

Operating margin and debt service coverage ratio. (i) Hospitals with an aggregate operating margin of less than 0.00 when calculated from the three most recent annual audited financial statements are not eligible for section 242 insurance, unless HUD determines, based on the financial data in those statements or other financial criteria or empirical information acceptable to HUD, that the hospital has achieved a financial turnaround resulting in a positive operating margin in the most recent year, calculated using classifications of items as operating or non-operating in accordance with guidance that shall be provided in accordance with generally accepted accounting principles or HUD is satisfied based on other available financial information or evidence acceptable to HUD that the project constitutes a reasonable underwriting risk.

The commenter stated that this change would permit flexibility, for example, in cases such as Critical Access Hospital applications where prior financial statements were allowed to be retroactively restated to reflect unusual circumstances such as prospective cost plus reimbursement. The commenter stated that negative historical operating margins may not always be relevant to a determination of a facility's prospective viability. For example, a hospital may have had an historical negative operating margin substantially, if not solely, as a result of excessive debt service, which may be fully eliminated through the proposed FHA financing. Similarly, a proposed mortgagor may be trying to reposition a struggling hospital and new or rehabilitated facilities, and equipment may enable that facility to compete more effectively, deliver services more efficiently, provide a higher quality of services, or offer new services without which a needed facility might never be able to improve its financial posture. The commenter states that negative historical margins should not result in automatic disqualification.

Response: HUD believes that in almost all cases, the proven ability to operate in the black is an essential prerequisite for consideration for mortgage insurance. Hospitals transitioning from the prospective payment system to cost-based reimbursement may recast financial results to present them as if they had been receiving cost-based reimbursement in prior years. In unusual circumstances, the applicant can request a waiver of the regulatory requirement for a positive operating margin.

Comment: The commenter states that there is no requirement that a start-up hospital (without an operating history) meet an historical operating margin test. To apply the standard automatically to an existing facility would seem discriminatory when, in fact, the new FHA financing may in and of itself allow the facility in question to meet or exceed required standards. HUD should also consider giving special financial consideration to Critical Access Hospitals, sole community, and disproportionate share providers where other financing options are prohibitively expensive or unavailable.

Response: It is true that start-up hospitals have no operating history to examine, and for that reason other factors become more important in HUD's review of the potential start-up mortgagor. However, when a hospital has an operating history, HUD must examine that history in evaluating the hospital's creditworthiness. HUD believes that demonstrated ability to operate in the black is the single most important indicator of financial strength and ability to repay debt. Note that an exception to the 3-year positive average operating margin may be granted in demonstrated financial turnaround situations.

This exception has been clarified in § 242.16(a)(2)(i). A hospital that has achieved a financial turnaround resulting in a positive operating margin in the most recent year may be considered eligible to *apply* for section 242 insurance. However, HUD does not anticipate *approving* an application unless the hospital has achieved two consecutive years of positive operating margin immediately prior to issuance of an insurance commitment. Accordingly, the following sentence has been added to the end of § 242.16(a)(2)(i):

In any event, HUD shall not issue an insurance commitment for any hospital that has not achieved two consecutive years of positive operating margin immediately prior to issuance of the commitment.

Comment: Section 242.16(a)(2)(ii) should be revised, as follows:

(ii)(A) Hospitals with an average debt service coverage ratio of less than 1.25 in the three most recent audited years are not eligible for section 242 insurance unless HUD

determines, based on the audited financial data, that the hospital has achieved a financial turnaround resulting in a debt service coverage ratio of at least 1.25 in its prior 12 month period, or other period acceptable to HUD, or HUD is satisfied based on other available financial information or evidence acceptable to HUD, that the project constitutes a reasonable underwriting risk.

(B) In cases of refinancing at a lower interest rate, HUD may authorize the use of the projected debt service requirement in lieu of the historical debt in calculating the debt service coverage ratios for each of the prior three years. In cases where HUD authorizes the use of the projected debt service requirement in lieu of the historical debt to determine the debt service coverage ratio, hospitals must have an average debt service coverage ratio of 1.40 or greater, or such lesser ratio as may be acceptable to HUD.

As to the first of these suggested changes, the commenter stated that the 1.40 standard should be revised to reflect the ''underlying 1.25 standard,'' particularly in situations where special financial consideration may be warranted, as described above. As to the allowance of a lesser debt service ratio, such a change would help promote flexibility as described above.

Response: HUD believes that the cash that was available historically to service debt is an important factor in considering a hospital's ability to service debt in the future. A debt service coverage ratio of 1.25 is considered quite low. The prospective debt service coverage ratio of 1.40 is generally the minimum HUD will tolerate in its underwriting of a mortgage insurance application. It is also quite low. The reason HUD will consider applications for hospitals with such low debt service coverage is that the Department recognizes its role in providing affordable financing to needed hospitals that are not financially robust enough to be of interest to private insurers. However, HUD believes that to accept even lower ratios would not be prudent.

Comment: Sections 242.16(a)(3) and (4) should be revised, as indicated:

(3) Financial Feasibility. The process for reviewing an application shall include an analysis of the financial feasibility of the proposal, i.e., an analysis indicating that it is probable that the proposed mortgagor will be able to meet its debt service requirements during the period projected. It includes analysis of the reimbursement structure of the proposed hospital (including patient/payer mix); actions of competitors; and the probable projected impact on the proposed hospital of general health care system trends, such as the development of alternative health care delivery systems and new reimbursement methods. In addition to historical operating margin, analysis of financial feasibility includes, but is not limited to, evaluation of the following factors. The application must address, and HUD will review, each of the following factors:

(i) Current and projected gains from operations and a manageable debt load using reasonable assumptions;

(ii) Current average debt service coverage ratio over a period determined acceptable by HUD of 1.25 or higher and projected debt service coverage ratio of 1.40 or higher, or such lesser ratio as may be acceptable to HUD;

(iii) Cushion in the balance sheet sufficient to demonstrate the ability to withstand short periods of net operating losses without jeopardizing financial viability;

(iv) Patient utilization forecasts (including average length of stay, case intensity, discharges, area-wide use rates) that are consistent with the hospital's historical trends, future service mix, market trends, population forecasts, and business climate;

(v) The hospital's demonstrated ability to position itself to compete in its marketplace;

(vi) Organizational affiliations or relationships that help optimize financial, clinical, and operational performance;

(vii) Management's demonstrated ability to operate effectively and efficiently, and to develop effective strategies for addressing problem areas;

(viii) Systems in place to monitor hospital operations, revenues, and costs accurately and in a timely manner;

(ix) A Board that is appropriately constituted and provides effective oversight;

(x) Required licensures and approvals; and

(xi) Favorable ratings from the Joint Commission on Accreditation of Healthcare Organizations or other organization acceptable to HUD.

(4) Preliminary Review. A Preliminary Review is a general overview of the acceptability of a potential mortgagor performed at the request of a lender, to identify any factors that would likely cause an application to be rejected, should an application be submitted.

(i) The purpose of the preliminary review is for HUD to identify any obvious factors that would cause an application to be rejected, before the potential mortgagor expends the resources needed to prepare an application and before HUD expends resources to review it. The lender shall submit a preliminary information package to HUD that provides evidence of statutory eligibility, market need, financial strength, and such other documentation as HUD may require.

(ii) If HUD identifies factors that would cause an application to be rejected, HUD shall issue a Preliminary Review Letter notifying the potential applicant that an application for mortgage insurance would result in a rejection and providing the reasons for this decision. Also, no further request from the proposed applicant for a Preliminary Review shall be entertained for a period of one year from the date of HUD's notification. HUD may grant an exception to this one-year limitation if, during the year, there is a major change in the circumstances that caused HUD to determine that the project would be rejected or if additional material information is provided with respect to the reasons on which a rejection is based and which justifies reconsideration of an adverse Preliminary Review Letter. For example, if the sole reason for HUD's determination was the hospital's failure to meet the historical operating margin test, and a new audited annual financial statement contains results that would cause the hospital to meet the test, then the lender may request a new Preliminary Review within one year of HUD's notification.

As to the projected debt service coverage ratio, the commenter stated that application of the proposed 1.40 standard for these purposes without a provision permitting Commissioner discretion to accept a lower projection, particularly where the FHA calculation deletes earnings and contributions, may preclude otherwise viable hospitals from program eligibility. As to the suggested change regarding consideration of additional material information, the commenter cited fairness given the potential one-year bar.

Response: The commenter had a number of suggestions. First, the commenter proposed language that says the application review will include an ''analysis of the financial feasibility of the hospital'' instead of a ''determination of the financial feasibility.'' HUD believes this change is unnecessary, as the meaning of ''determination'' is discussed immediately thereafter.

The commenter suggests using ''during the period projected'' instead of ''during the life of the proposed mortgage'' when highlighting the period in which HUD will determine financial feasibility. This change is accepted.

The commenter suggested lowering the standard of the debt service coverage requirement by adding language stating that HUD may consider a lesser ratio. HUD rejects this response; please see the response to the previous comment on § 242.16(a)(2)(ii) for more information.

The commenter suggests requiring that only lenders (as opposed to a hospital, a financial consultant representing a hospital, or a lender) request a preliminary review. HUD has, in the past, accepted requests for preliminary reviews from hospitals and consultants. In some cases, hospitals wish to assess their eligibility prior to retaining a mortgage banker. HUD will keep the existing language and notes that pre-application meetings for projects with a positive preliminary review require the participation of the proposed mortgagor's mortgage banker.

The commenter suggests replacement of the word ''applicant'' in (4)(i) with the word ''mortgagor.'' HUD has replaced ''applicant'' with the words ''mortgagor or mortgagee'' to reflect that

both may expend resources in preparing an application.

The commenter suggests adding language further describing under what circumstances HUD may reconsider an adverse preliminary review. In its current form, the ''Commissioner may grant an exception * * * if there is a major change in circumstances that caused'' the rejection. Specifically, the commenter suggests adding ''or if additional material information is provided with respect to the reasons on which a rejection is based and which justifies reconsideration of an adverse Preliminary Review.'' HUD considers this added language to be repetitive. Thus, the existing language will remain.

Comment: In accordance with a comment to § 242.1, above, the term ''mortgagor'' should be substituted for the term ''applicant'' in proposed § 242.16(a)(5).

Response: HUD agrees that the term ''mortgagor'' is clearer and the change has been made.

Comment: One commenter stated as to § 242.16(b)(6) that the following should be added to the current ''architectural plans and specifications'': ''* * * to the extent available when the application is filed.'' The commenter stated that usually architectural plans are not available when the application is submitted.

Response: HUD does not intend to require that complete architectural plans and specifications be submitted when a complete application is received. However, the addition of language stating that the drawings and specifications may be submitted ''to the extent available when the application is filed,'' as suggested by the commenter, is insufficient. Accordingly, the language in 242.16(b)(6) will be changed, as follows: ''Architectural plans and specifications in sufficient detail to enable a reasonable estimate of cost.''

Comment: One commenter stated that § 242.16(b)(8) should be revised, as indicated:

> If the State has an official procedure for determining need for hospitals, evidence that such procedure has been followed and that need has been established under that procedure; provided that as set forth in Section 242.16(a)(1)(i) hereof, HUD may allow an application to be filed in certain circumstances acceptable to HUD.

Response: The additional language is not necessary since HUD interprets the statute, 12 U.S.C. 1715z–7, to require that the certificate of need will be submitted as part of the application.

Comment: One commenter stated that § 242.16(b)(9) should be revised, as indicated:

> If HUD has authorized the Department to conduct the environmental study required as a condition of mortgage insurance, evidence of compliance with Federal and State environmental regulations; if HUD has not commissioned such study, the study shall be commissioned and completed prior to the issuance of a commitment.

Response: HUD does not perform the initial environmental site assessment; this is the responsibility of the mortgagor or mortgagee. The application must include a Phase I environmental report and, if Phase I indicates that further study is required, evidence and results of the further study.

Comment: One commenter stated that § 242.16(e) should be revised, as indicated:

> Complete application. Only materially complete applications will be processed. Except as otherwise provided in this subpart, partial applications cannot be processed. Upon determination that an application is complete, HUD shall issue a Completeness Letter to the applicant stating that the application is complete. Such letter shall be issued within two weeks of the receipt of an application which is in compliance with this section.

The commenter states that the term ''technically complete'' is unnecessarily vague and that ''materially complete'' is an appropriate and common industry standard.

Response: Regarding the first comment, HUD does not see an advantage in using the term ''materially'' complete over ''technically'' complete. Maintaining the term ''technically'' is a higher standard that will ensure applications are deemed complete only when all the information has been received in a satisfactory form. In certain cases, HUD will deem an application complete when only very minor items are missing and the applicant has agreed to supply HUD with these items in less than 2 weeks' time.

Concerning the second change, HUD will not commit to a 2-week deadline for the return of a Completeness Letter. It is an internal guideline that staff will make every effort to meet; however, factors beyond HUD's control may at times prevent the Department from meeting that guideline.

Comment: The last sentence of § 242.16(f) should be revised, as indicated:

> (f) * * *. It is the intent to communicate HUD's decision with respect to a project as promptly as possible after receipt of a completed application in the form of a Commitment Letter or a Rejection Letter, but HUD shall be under no obligation to issue such letter within a predetermined timeframe.

The commenter stated that, although the completion of a Section 242 application is not subject to predictable timeframes and that unreasonable borrower expectations have been created when timeframes have been expressed, the inclusion of a 12-month timeframe standard will be extremely detrimental to the program and discouraging to borrowers. As a practical matter, the simple and clear statement suggested above would allow FHA to accomplish its objectives without the negative and dispiriting implication represented by a 12-month timeframe.

Response: HUD agrees that referencing a 12-month timeframe may discourage borrowers by causing them to believe that 12 months are routinely required. That reference has been removed.

2. Section 242.17 Commitments

Comment: Section 242.17(a)(1) should be revised to permit insurance upon completion, as well as insurance upon advances. According to the commenter, this would maintain ''maximum levels of flexibility to deal with the multiple and unique circumstances of healthcare providers.''

Response: Insurance upon completion was considered by HUD, but left out of the rule. HUD has never had a request for insurance upon completion and does not have procedures in place to allow applicants to use this procedure. Therefore, the final rule has not been changed to include insurance upon completion.

Comment: Section 242.17(c)(2) should be revised to permit commitments to be extendable beyond 180 days with the approval of HUD. The commenter states that a commitment period of more than 180 days may occasionally be required to permit a mortgagor to comply with commitment terms and conditions and to complete arrangements in connection with the financing of the insured loan, particularly when the financing source is revenue bond proceeds.

Response: After 6 months, factors such as construction costs, interest rates, the hospital's actual financial performance, and others that were considered by HUD as reasons for issuing a commitment, can change. Substantial resource expenditure can be involved in HUD's re-evaluation of the financial feasibility of the project in light of changing circumstances. Further, an analysis of insured hospital mortgages that were initially endorsed during the prior 3 years indicates that in only one case did the hospital require more than 6 months between commitment and initial endorsement.

Therefore, HUD believes that if the mortgagor cannot be prepared to go to initial endorsement within 6 months after receiving a commitment, and later determines that it is ready to proceed to initial endorsement, the procedures described in § 242.20 should be followed to request a reopening of an expired commitment. For these reasons, HUD does not adopt this comment.

Comment: Section 242.17(d) should be revised, as indicated:

> Commitment fee. A commitment fee which, when added to the application fee, will aggregate $3.00 per thousand dollars of the amount of the loan set forth in the commitment, shall be paid at or prior to initial endorsement.

Response: It is possible that an applicant who receives a commitment may find other means of financing prior to initial endorsement. Under the commenter's proposal, HUD would not collect a commitment fee in this case. HUD sees no need to encourage a situation where HUD does not collect a commitment fee after expending considerable resources in review of an application.

3. Section 242.18 Inspection Fee

Comment: Section 242.18 should be revised, as indicated:

> The commitment may provide for the payment of an inspection fee in an amount not to exceed $5 per thousand dollars of the commitment amount. In determining the amount of such inspection fee, HUD shall consider the amount of the loan that is being applied to the refinancing of the hospital's existing indebtedness. The inspection fee shall be paid at the time of initial endorsement or in the case of a start of construction prior to initial endorsement, such earlier time as HUD may require.

The commenter states that, unlike most multifamily housing projects, Section 242 hospital mortgages often include refinancing components substantially exceeding new construction costs and related expenses. To charge the inspection fee on the full mortgage amount in such cases would seem inappropriate. HUD Handbook 4480.1 specifies that in the case of rehabilitation or reconstruction of an existing structure, the HUD-FHA Inspection Fee is computed on the cost of new improvements and mortgageable equipment. The commenter states that specific language to this effect should be included in the new regulation.

Response: Regardless of the amount of the refinancing, HUD's mortgage on the property demands that it perform a full inspection of the property. Because of the complexity of hospital facilities, the inspection involves a great amount of work regardless of whether there is a refinancing component. The inspection fee reflects this effort. Basing the inspection fee on the full amount of the proposed mortgage is consistent with long-standing practice. The final rule, therefore, retains the proposed language concerning inspection fees.

4. Section 242.19 Fees on Increases

Comment: Section 242.19 should be revised, as indicated:

> (a) Increase in commitment prior to endorsement. An application, filed prior to initial endorsement, for an increase in the amount of an outstanding commitment, shall be accompanied by an additional application fee of $1.50 per thousand dollars computed on the amount of the increase requested. Any increase in the amount of a commitment shall be subject to the payment of an additional commitment fee which, when added to the additional application fee, will aggregate $3.00 per thousand dollars of the amount of the increase. The additional commitment fee shall be paid at initial endorsement of the related mortgage increase. If an inspection fee was required in the original commitment, an additional inspection fee shall be paid in an amount not to exceed $5.00 per thousand dollars of the costs of construction represented in the increase in commitment. The additional inspection fee shall be paid at the time of initial endorsement.
>
> (b) Increase in mortgage between initial and final endorsement. Upon an application, filed between initial and final endorsement, for an increase in the amount of the mortgage, by amendment, supplemental consolidated mortgage or by substitution of a new mortgage, an additional application fee of $1.50 per thousand dollars computed on the amount of the increase requested shall accompany the application. The approval of any increase in the amount of the mortgage shall be subject to the payment of an additional commitment fee which, when added to the additional application fee, will aggregate $3.00 per thousand dollars of the amount of the increase granted. If an inspection fee was required in the original commitment, an additional inspection fee shall be paid in an amount not to exceed $5.00 per thousand dollars of the amount of the increase granted based on the amount of construction set forth in the mortgage increase ratio. The additional commitment and inspection fees shall be paid within 30 days after the date that the increase is granted or at the endorsement of such mortgage increase by HUD.

Response: Delay of payment of the additional commitment and inspection fees is not in the best interest of the program, for the reasons given in the responses to comments on §§ 242.17(d) and 242.18. The proposed change to add ''supplemental consolidated mortgage'' has been implemented by adding ''consolidation agreement'' in § 242.19(b). The remaining changes proposed to this section have not been included in the final rule for reasons described above.

5. Section 242.20 Reopening of Expired Commitments

Comment: One commenter states that this section should be revised to permit waiver of the reopening fee ''solely on grounds acceptable to HUD.''

Response: In the proposed regulation, a commitment expires after 90 days and may be extended to 180 days. If a commitment expires, the proposed rule provides that within 90 days of expiration, the applicant may request a reopening. In this case, 6 to 9 months will have passed since the original commitment. With the passage of so much time, the basis for HUD's issuance of the commitment may no longer be valid. HUD would have to review changes in construction cost, interest rates, actual performance of the hospital, and other factors to determine whether to grant the request for reopening. That review would require an expenditure of HUD resources, for which a fee is appropriate. HUD believes that a waiver process would not be productive. Therefore, HUD does not adopt the comment.

6. Section 242.21 Refund of Fees

Comment: The regulation should address whether the portion of the inspection fee that is related to pre-commitment work or early start is refundable if the conditions described in § 242.21 are met as the government has expended resources prior to the initial closing at the request of the hospital.

Response: The inspection fee in the case of early commencement of work will be non-refundable. For a full discussion of issues concerning early commencement of work, see the response to comments on § 242.45, as well as the final version of that section.

7. Section 242.22 Maximum Fees and Charges by Mortgagee

Commenter: The subject section should be revised, as indicated:

> The mortgagee may collect from the mortgagor a total financing fee for origination and placement of a mortgage loan in an amount not to exceed five and one half percent of the original principal amount of the mortgage, as agreed upon by mortgagee and mortgagor and approved by HUD. Any additional charges or fees, unless paid from non-mortgage sources, collected from the mortgagor shall be subject to prior approval of HUD and shall be disclosed in the Mortgagee's Certificate.

This commenter states that, as a practical matter, the traditional multifamily separate categorization of

FHA financing fees as origination and placement have been effectively eliminated in the Section 242 program, where such fees are often aggregated into a single financing fee. This aggregate approach has been particularly helpful for hospital loans financed with tax-exempt revenue bonds, where placement-related costs are generally higher than those for taxable financings and origination fees are lower. FHA should consider describing the fee structure as a single aggregate line item not to exceed 5.5 percent.

Response: Current policy in the Section 242 program is to limit financing and placement fees to a total of 3.5 percent, with an exception to allow a total of 5.5 percent, on a case-by-case basis, when so requested by the mortgagee. The proposed rule brings the Section 242 program in agreement with all other Multifamily Mortgage Insurance programs. The maximum financing fee the mortgagee may charge is 3.5 percent of the mortgage amount, with a maximum of 2 percent for the initial financing charge and the remainder of the 3.5 percent for the permanent financing fee.

Higher fees up to 5.5 percent are permissible in bond transactions. Where the proposed financing is through the sale of either taxable or tax-exempt bonds, the maximum financing fees allowable in the mortgage computation and recognizable for cost certification purposes is 5.5 percent of the mortgage amount. Any cost beyond the 5.5 percent must be paid from sources outside the mortgage.

The maximum financing fee the mortgagee may retain for its own account is 3.5 percent (for the initial financing fee and permanent financing fee, as indicated above). The remaining 2 percent (or such greater percentage as may result from the lender reducing its maximum retainable 3.5 percent fee) may be used to offset the cost of bond fees.

Comment: In some states, for example New York, state and local governments charge fees in connection with tax-exempt revenue bonds and certificates of need. Therefore, HUD should consider a separate capitalized line item for state and local government fees.

Response: A new capitalized line item to cover such costs would be beyond the scope of the proposed rule.

8. Section 242.23 Adjusted and Reduced Mortgage Amounts

Comment: One commenter states that rehabilitation projects under this section should explicitly include project expansion, and suggests inserting language in § 242.23(a) and § 242.23(a)(2)(i) to this effect. Additionally, in § 242.23(a)(3)(ii), the commenter states that the phrase ''value of'' should be deleted.

Response: The term ''substantial rehabilitation'' is broad and encompasses projects that expand the facility. See comments and responses to § 242.4 and to the definition of ''project'' at § 242.1. The first occurrence of the phrase ''value of'' in proposed § 242.23(a)(3)(ii) was superfluous and is removed in this final rule.

Comment: Section 242.23(c) on cash equity should be revised, as indicated:

> Cash equity. Depending upon the financial circumstances of each hospital facility, HUD shall have the discretion to evaluate, on a case-by-case basis, the amount of cash equity that a mortgagor must supply in addition to the value of plant, property and equipment and other values recognized as loan security in the commitment process. Exercise of this discretion shall never cause a loan to exceed 90 percent of estimated replacement cost, although it may cause it to be less than 90 percent. The equity contribution may not be made from borrowed funds. A private nonprofit or public mortgagor, but not a proprietary mortgagor, in the mortgagee's discretion and subject to 24 CFR 242.49, may provide any such required equity in the form of a letter of credit or surety bond issued by an insurance company acceptable to HUD.

The commenter states that historically, nonprofit hospitals have been permitted to post required non-PPE (property, plant, and equipment) equity at Initial Endorsement in the form of a letter of credit, a privilege stated in Section 242(d) of the NHA. The commenter states that the letter of credit privilege should be augmented to permit equity to be posted in the form of ''surety bonds'' issued by an acceptable insurance company such as AMBAC, FGIC, MBIA, or FSA. The surety bond alternative would represent an opportunity for institutions to fund equity at more competitive costs.

Response: HUD agrees with the suggested changes to the first and second sentences. However, HUD does not agree to delegate to the mortgagee the determination of the form the equity should take. Nor does HUD agree that surety bonds are an acceptable form of equity. Such delegation and use of surety bonds for equity do not offer the level of protection the Department considers necessary.

§ 242.23(c) is revised as indicated:

> Cash equity. Depending upon the financial circumstances of each hospital facility, HUD shall have the discretion to evaluate, on a case-by-case basis, the amount of cash equity that a mortgagor must supply in addition to the value of plant, property, and equipment and other values recognized as loan security in the commitment process. Exercise of this discretion shall never cause a loan to exceed 90 percent of estimated replacement cost, although it may cause it to be less than 90 percent. The equity contribution may not be made from borrowed funds. A private nonprofit or public mortgagor, but not a proprietary mortgagor, in HUD's discretion and subject to 24 CFR 242.49, may provide any such required equity in the form of a letter of credit.

To further clarify § 242.23, HUD has changed its title to ''Maximum Mortgage Amounts and Cash Equity Requirements.''

9. Section 242.24 Working Capital

Comment: The title of this section should be revised to ''Reserve for start-up costs.''

Response: The title is changed to ''Initial Operating Costs,'' as discussed in the response to a comment on the definition of ''Working Capital'' in proposed § 242.1.

Comment: The section should be revised, as indicated:

> In the case of a new hospital or a hospital expansion, HUD shall establish, on a case-by-case basis, the amount of capital, if any, that must be deposited in cash, a letter of credit or surety bond (or any combination thereof) to be available to the new hospital upon commencement of operations. Generally, the working capital other than AMPO shall not be borrowed funds unless HUD determines that there are offsetting financial strengths to compensate for the risk associated with borrowing.

The term ''hospital expansion'' as used in this section is unclear and the mandatory nature of the section is a concern. If the term ''expansion'' includes substantial rehabilitation, cash (or letters of credit) capital escrows are often not required, depending on the borrower's financial wherewithal. Moreover, even if the term does not include substantial rehabilitation, but only new construction or an expansion, the mandatory nature of the requirement would not be necessary if existing operations demonstrated that such capital was available from other sources. The commenter states that AMPO (Allowance to Make Project Operational) in the case of nonprofit sponsors would also be a source of such capital. The commenter suggested that the phrase ''if any'' be added to allow for a case-by-case determination based on the general financial condition of a sponsor.

Response: HUD did not intend to make an initial cash deposit a mandatory requirement. The amount of cash deposit, or whether HUD will require such a deposit at all, depends on the borrower's financial strength and will be a case-by-case determination.

For this reason, HUD agrees with the addition of ''if any.''

HUD disagrees with the notion of allowing the use of surety bonds, as HUD does not believe that they provide sufficient protection. HUD also believes that the commenter's treatment of AMPO is correct, and this final rule adds a definition of AMPO to § 242.1.

Subpart C—Mortgage Requirements

1. Section 242.25 Mortgage Form and Disbursement of Mortgage Proceeds

Comment: Section 242.25(b) should be revised, as indicated:

Disbursement of mortgage proceeds. The mortgagee shall be obligated, as a part of the mortgage transaction, to disburse the principal amount of the mortgage in accordance with the governing building loan agreement acceptable to HUD in the case of a construction or rehabilitation mortgage and in the case of refinancing of mortgages without construction or rehabilitation, in accordance with procedures acceptable to HUD.

Response: The commenter assumes that § 242.25(b) of the regulation intends to implement section 223(f) of the National Housing Act, 12 U.S.C. 1715n(f), which is not the case. The proposed language is clear and is retained in this final rule.

2. Section 242.26 Agreed Interest Rate

Comment: The term ''rate'' in this section should be revised to ''rate or rates'' to reflect the fact that construction and permanent interest rates often differ, as well as to allow for circumstances that arise, when a state agency (for example, the New York Department of Health) requires that refinanced debt be repaid pursuant to a schedule shorter than the FHA amortization period. In either event, it is understood that the project interest rate will not exceed the rate stated in the governing FHA commitment.

Response: HUD agrees that more than one rate may be applicable, and therefore makes the suggested change in this final rule.

3. Section 242.27 Maturity

Comment: The maturity date should be up 35 years, rather than the proposed 25. The commenter states that, as a means of reducing a hospital's monthly debt service burden, Section 242 (and Section 241) amortization periods should approach those used in multifamily housing programs, including nursing homes. Although the amortization of Section 242 loans has historically been 25 years, that standard is not a requirement of the NHA. Moreover, other FHA programs, including FHA's Section 232 program, permit post-construction amortization periods as long as 40 years post-amortization, thereby permitting lower annual debt service as well. The commenter states that longer amortization periods are commonly used in non-FHA commercial hospital finance programs.

Response: Congress has always understood the maximum term to be 25 years and it has been 25 years since the inception of the program, when it was established by regulation. It was deliberately set at 25 when rental project terms were 30 to 40 years, because hospitals become obsolete faster and the equipment (a major component) ages much faster. HUD believes that these reasons support continuation of the current policy, as stated in the proposed rule.

4. Section 242.28 Allowable Costs for Consultants

Comment: Section 242.28 should be revised, as indicated:

Consulting fees for work essential to the development of the project may be included in the insured mortgage. Allowable consulting fees include those for analysis of market demand, expected revenues, and costs; site analysis; architectural and engineering design; fees paid in connection with obtaining a state required certificate of need and other governmental required fees; and such other fees as HUD may determine to be essential to project development. Fees for work performed more than one year prior to preliminary review of a proposed application are not allowable unless such work is directly attributable to and for the benefit of the project as determined by HUD, such as architectural fees. Fees for work performed by any party with an identity of interest with the proposed mortgagor or mortgagee are not allowable unless such fees are determined to be reasonable by HUD.

The commenter disagrees with the one-year limitation and believes that in certain situations the limitation may be unreasonable, particularly in connection with fees for project architects, debt capacity, financial feasibility or planning consultants, and construction managers. These firms are often retained for project development purposes prior to the one-year limitation.

Response: With respect to certificate of need and other government fees, see the response to the second comment on § 242.22, regarding fees. In addition, HUD considered the commenter's suggestion regarding fees paid in connection with obtaining a state-required Certificate of Need. The fees associated with conducting a feasibility study to determine need for construction or substantial rehabilitation of a hospital, as part of the Certificate of Need process, are not includable as costs in the insured mortgage. This step pertains to the submission of an application to the state to determine if the proposed project is required to serve the health needs of the community. However, fees associated with a Study of Market Need and Financial Feasibility can be included in the insured mortgage, because the HUD-required study is used primarily by HUD to determine the need for the hospital and the ability of the hospital to service its mortgage debt.

With respect to the one-year limitation, HUD notes that in some cases several years can pass between preliminary review and application submission, making it difficult to verify the relevance to the application and the cost of consultant services. However, recognizing that hospital projects can require long lead times for planning, HUD has increased the proposed one-year limitation to 2 years in this final rule. With respect to identity of interest, HUD believes that consultants by their very nature should be independent of the mortgagor and the mortgagee. For these reasons, this final rule does not adopt the commenter's suggested changes concerning identity of interest consultants.

5. Section 242.29 Payment Requirements

Comment: Section 242.29 should be revised to include interest in arrears, as follows:

The mortgage shall provide for payments including interest in arrears on the first day of each month in accordance with an amortization plan agreed upon by the mortgagor, the mortgagee and HUD.

Response: HUD does not consider this level of detail to be necessary in the final rule.

6. Section 242.31 Accumulation of Accruals

Comment: One commenter states that § 242.31(b) should be revised to permit greater flexibility in purchasing fire and hazard insurance, as follows:

The mortgage shall provide for such equal monthly payments by the mortgagor to the mortgagee as will amortize the ground rents, if any, and the estimated amount of all taxes, water charges, special assessments, and fire and other hazard insurance premiums, within a period ending one month prior to the dates on which the same become delinquent. The mortgage shall further provide that such payments shall be held by the mortgagee, for the purpose of paying such items before they become delinquent. The mortgage shall also make provision for adjustments in case such estimated amounts shall prove to be more, or less, than the actual amounts so paid therefore by the mortgagor. Notwithstanding the foregoing, in

certain circumstances, a mortgagor may purchase required fire and hazard insurance through a consortium of affiliated institutions or related organizations or in the case of public institutions, through required state purchasing arrangements. In such circumstances, the mortgage accrual requirement may be modified to reflect such circumstances.

The commenter states that in some situations, property insurance may be purchased and paid for through a consortium of affiliated hospitals or a state system under state required arrangements, and the rule should allow for this flexibility.

Response: The commenter's point is well taken and HUD agrees to the language proposed for addition, with a change in the last sentence, as follows:

In such circumstances, the mortgage accrual requirement may be modified to reflect circumstances in which it is inappropriate for the mortgagee to collect monthly payments and to make payments on behalf of the mortgagor.

7. Section 242.33 Covenant for Malpractice, Fire, and Other Hazard Insurance

Comment: FHA's required mortgage form, a real estate-oriented security document, appropriately requires insurance coverage related to real and personal property interests that secure repayment of a loan. Malpractice insurance on the other hand is not real estate-related and would be more appropriately covered in the project Regulatory Agreement. The commenter also notes that malpractice insurance may on occasion be covered in part under self-insurance vehicles. Flexibility should be allowed for those purposes, as well. Finally, the concept of ''adequate * * * coverage'' should be clarified, possibly to reflect the advice of an insurance consultant or other experienced industry expert.

Response: Regardless of local practice, HUD must be able to require an assurance that adequate malpractice coverage be maintained. This final rule adopts language requiring the mortgagor to maintain adequate coverage acceptable to the mortgagee and HUD. This language will maintain flexibility while protecting the mortgagee and the insurance fund.

Comment: Commenter (3) stated that there should be language included to ensure that appropriate amounts of insurance are funded. State pools should be acceptable, and offshore insurance accounts should be acceptable if approved by HUD. Risk retention groups and captive insurance companies should also be acceptable if approved by HUD. The regulation should address whether or not the insurance carriers meet minimum rating standards.

Response: The language of the final rule provides sufficient flexibility to consider alternative sources of insurance, and to provide that insurance is adequate and acceptable.

8. Section 242.35 Mortgage Lien Certifications

Comment: Section 242.35 should be deleted in the final rule, because the certifications required are more in the nature of legal opinions to be rendered by counsel in the jurisdiction where a project is located. If the section is not deleted, it should be revised to provide for such exclusions, liens, and security instruments as are acceptable to HUD. In accordance with existing practice, exceptions should be provided for such items as prior leased equipment, utility easements, and other title exceptions acceptable to HUD.

Response: HUD sees no reason to exclude certain property from the mortgage lien. The language in the final rule is needed to implement the statute and fully protect the interests of HUD. However, the proposed language of this section is changed in this final rule so that in exceptional cases certain personalty may be excluded from the mortgaged property or the insured lender may take a secondary lien position on it. Also, the final rule removes the requirement for formal certification.

9. Section 242.37 Mortgage Prepayment

Comment: Section 242.37(a) should be revised, as follows:

Prepayment privilege. Except as provided in paragraph (c) of this section or otherwise established by HUD, the mortgage note or credit instrument shall contain a provision permitting the mortgagor to prepay the mortgage note or credit instrument in whole or in part upon any interest payment date, after giving the mortgagee a minimum of 30 days notice in writing in advance of its intention to so prepay.

The purpose of these revisions is to provide for alternative notice requirements where required to comply with investor financing arrangements. For example, in order to obtain AA/AAA ratings for bonds that provide the source to finance Section 242 mortgages, prepayments must be bankruptcy-proof (held for periods between 90 and 125 days, depending on state or federal law). In order for mortgage prepayments to be protected, therefore, a longer notice and tendering period should be permitted.

Response: HUD has retained the language in § 242.37(a), but in order to accommodate the scenario that the commenter identifies has added a sentence permitting HUD to extend the notice.

Comment: The term ''mortgage'' in this section should be revised to read ''mortgage note or credit instrument.''

Response: ''Mortgage'' is a defined term in the rule. HUD considers the existing definition of ''mortgage,'' which includes appropriate credit instruments, to be sufficient, and it is not necessary to repeat the definition with each individual usage of the word.

Comment: One commenter stated that § 242.37(b)(1) should be deleted because ''the provision is virtually unknown in the commercial sector and may affect the marketability of the FHA debt in secondary markets, particularly in the case of tax-exempt bonds, resulting in higher than necessary interest rates.'' Additionally, the commenter stated that the rule or an accompanying publication should contain additional guidance regarding acceptable prepayment restrictions and premiums to eliminate ''field office counsel uncertainty.'' The terms and conditions should be similar to those for multifamily projects and should provide for Commissioner exceptions where warranted to deal with investor market conditions and preferences.

Response: This concern is addressed in 242.37(c), which provides that the mortgage may contain prepayment restrictions acceptable to HUD in the case of mortgage-backed securities or bond funding.

Comment: Section 242.37(d) should be revised to read ''mortgage default'' instead of ''default.''

Response: HUD needs to have the ability to take the appropriate action if there are regulatory agreement defaults, not only a mortgage default. Thus, the broad proposed language (''default'' as opposed to ''mortgage default,'' as suggested) is maintained in the final rule.

Subpart D—Endorsement for Insurance

1. Section 242.39 Insurance Endorsement

Comment: The term ''credit instrument'' used in the section is undefined and at a minimum should include a mortgage or deed of trust note or other evidence of indebtedness secured by a mortgage. The commenter also suggested editing § 242.39(c) to read, as follows:

Contract rights and obligations. HUD and the mortgagee or lender shall be bound from the date of initial endorsement by the provisions of the Contract of Mortgage Insurance set forth in subpart B of Section 207 of 24 CFR part 200.

Response: HUD has replaced the term ''credit instrument'' with ''mortgage note,'' to be consistent with the definition of ''mortgage'' in § 242.1. HUD agrees with the suggestion to revise § 242.39(c). That revision, which is adopted in this final rule, makes proposed § 242.94 unnecessary; therefore, that section is omitted from this final rule.

2. Section 242.43 Application of Cost Savings

Comment: One commenter states that this section should be revised, as indicated:

Any cost savings identified through the cost certification process shall be used to:

(a) Reduce the principal amount of the mortgage and the mortgagor's cash equity contribution proportionally or in such other manner as may be approved by HUD subject to the program's 90 percent loan to cost requirement, and/or

(b) Fund in whole or part, any additional construction, modernization, rehabilitation, purchase of equipment or costs related thereto approved by HUD.

The commenter states that in addition to proportional allocation, the rule should allow HUD to allocate higher amounts to project equity based on the financial circumstances of a particular mortgagor, provided that the loan-to-cost ratio is sustained. In some circumstances, particularly where mortgagor liquidity may be an issue post-construction, this result may be of benefit both to FHA and the hospital. In other cases, mortgagors may have voluntarily committed more equity to project construction than FHA would have required.

Response: HUD agrees that a proportional reduction of the mortgage amount and the equity contribution should not necessarily be the mortgagor's only option. The final rule would allow the mortgagor, at HUD's sole discretion, to elect to apply a greater percentage of the cost savings to reduce the principal amount of the mortgage. The mortgagor should not be required to borrow funds that are not needed for the project. HUD does not agree that higher amounts should be allocated to project equity, because to do so would amount to using borrowed funds for working capital, which is not a permitted use of mortgage proceeds. Additionally, HUD has revised § 242.43(b) to make that section consistent with the definition of ''substantial rehabilitation'' in this final rule.

Subpart E—Construction

1. Section 242.45 Early Commencement of Work

Comment: One commenter states that a new § 242.45(a) entitled ''Pre-application work'' should be added and that a number of other revisions to the section should be made. The entire section would read, as follows:

(a) Pre-application work. (1) Project work may be undertaken and completed by the mortgagor prior to filing an application. Such work must meet all applicable local and state requirements for the type of work undertaken and completed and be at the sole risk and responsibility of the mortgagor. At the discretion of HUD, and upon such terms as HUD may prescribe, a loan made to mortgagor in connection with such work may be refinanced from mortgage loan proceeds, or, in the alternative, HUD, in its sole discretion, may recognize all or part of such cost as a mortgagor contribution to any equity requirement set forth in the commitment.

(2) With the prior approval of HUD, pre-application work that will not be completed before the filing of an application may be undertaken by mortgagor at its sole risk and responsibility, provided that all applicable local, state and federal requirements, including the payment of prevailing wages, environmental review under § 242.79, inspections by appropriate federal agencies, payment of FHA inspection fees, and such other requirements as may be imposed by HUD are met as if such work were to be approved for mortgage insurance. If, with HUD's approval, a loan to mortgagor in connection with such pre-application work will be re-financed with mortgage proceeds, that work must be completed to the satisfaction of HUD before initial endorsement of the mortgage loan. If, with HUD's approval, such project work will continue beyond the date of initial endorsement, the expense of such work may, in HUD's sole discretion, be included in the mortgage loan or recognized in whole or in part as a mortgagor contribution to any equity requirement set forth in the commitment, upon such terms and conditions as HUD may prescribe.

(b) Pre-commitment work. After an application has been filed, but prior to the issuance of a commitment by HUD, the mortgagor may request for good cause the commencement of work on the project within legal guidelines and State law. Such work, and the request therefor, shall be subject to the same requirements, conditions and provisions set forth in Section 242.45(a)(2).

(c) Early Start. Subsequent to the issuance of a commitment, if the mortgagor requests the commencement of the project, the work may commence after the review of the request by HUD, including the environmental review under Section 242.79, and the agreement to certain conditions by the mortgagor. Prior to the initial endorsement, the work is accomplished at the sole risk of the mortgagor.

(d) Prepayment of inspection fee. The mortgagor shall pay the inspection fee to HUD before pre-application work pursuant to Section 242.45(a)(2), pre-commitment or early start work commences.

(e) Work started prior to application submission. HUD has the sole discretion to allow such work to be incorporated into the application if, except for work undertaken and completed as set forth in Section 242.45(a)(1), HUD has reviewed and approved the drawings and specifications and has inspected the work.

(f) No expressed or implied intent. Approval to proceed under paragraphs (a), (b), and (c) of this section shall in no way be construed as indicating any intent, expressed or implied, on the part of HUD to approve, disapprove, or make any undertaking or promise whatsoever with respect to the application or with respect to any commitment for mortgage insurance. Any work under paragraphs (a), (b) and (c) of this section shall be accomplished at the sole risk and responsibility of the mortgagor.

These revisions would allow for work on an insured hospital to be done at various times, including prior to an application being filed. The commenter states that at various times over the course of many years of dealing with the Section 242 program, there has been a need for hospitals to begin different types of project-related construction or preparation for such construction for a host of reasons. For example, in some cases construction needed to be commenced early in order to preserve favorable bids from subcontractors or to be ''under roof'' before the onset of winter weather. In other, more complicated phased construction situations, overall completion timing depended on the timely sequential start of each phase, particularly if patient, office, or other service ''decanting'' from one building to another was required. This was particularly true if a building within a fully operational hospital needed to be vacated before it could be rehabilitated, expanded, or demolished to make way for a new structure. In other instances, state or local governmental requirements came into play; for example, the expiration of a building permit or a certificate of need if work were not started by a particular date. The impact of rising interest rates and construction costs has also been a factor in a hospital's decision to undertake and finance pre-application or pre-commitment work (and FHA's decision to approve such work), since such work is at the hospital's risk and expense with no assurance that FHA financing will be available at a later date. Finally, nonprofit hospitals involved in fund-raising campaigns to cover required Section 242 equity and other requirements (or to avoid mortgage loans greater than might otherwise be necessary) have learned that donor interest and levels of

philanthropy will often be higher if potential benefactors can see tangible evidence of new construction or rehabilitation through early construction activity.

All of these considerations have been addressed by HHS and FHA over the years in one form or another as the basis of approving various arrangements for early construction within the confines of governing regulations and statute. Congress also appears to have recognized one of these concerns, the timing of fund-raising activities, by permitting letters of credit in lieu of cash to be utilized to fund project equity by public and nonprofit sponsors under Section 242(d) of the NHA.

Beginning in the early 1980s and continuing to date, a series of HUD opinions and approvals (starting with those for South Nassau Communities Hospital) have been issued to permit variations of pre-application, pre-commitment, and early start work without artificial or unnecessary restrictions beyond meeting governing law, regulations, or other requirements reasonably established to protect the soundness of the mortgage insurance program. The Committee's proposed revisions to Section 242.45 are intended to assure that policies approved to date for these purposes are continued, as well as to provide latitude for reasonable policy adjustments to be made in the future on a case-by-case basis, so long as they comport with federal, state, and local requirements and do not increase FHA's insurance risk.

Response: HUD understands that there are situations such as those described by the commenter in which it is to the advantage of the proposed mortgagor to begin construction prior to receipt of an insurance commitment. At the same time, HUD is concerned that a regulation encouraging such work could result in pre-application and pre-commitment work becoming the rule rather than the exception. Gradually, the focus of the program could become insurance upon completion. HUD's long-standing policy has been not to implement insurance upon completion for Section 242. A second concern is that HUD's authority to expend resources on reviews and inspections of construction is questionable in cases where HUD has received no application.

HUD believes that there is a solution that addresses HUD's concerns while permitting limited project construction to be started in cases such as those described in the comment. That solution would be for the mortgagee and mortgagor together to file an application consisting, at minimum, of: The approved FHA form, the application and inspection fees, a project description, architectural plans and specifications for the initial construction, previous participation review information, a Phase I environmental report, and a certificate of need for the pre-commitment work if required by the state. The remainder of the application could be submitted at a later date. The application would be accompanied by a request for the initial construction to be financed with insured mortgage proceeds and assurance that, should the full application be denied, the mortgagor will not experience significant financial hardship.

With respect to construction completed prior to application, HUD does not intend to implement insurance upon completion, as stated above. However, HUD recognizes that hospitals are dynamic entities that have a need for construction or rehabilitation from time to time, and that a proposed mortgagor may have completed construction or rehabilitation in the recent past. HUD believes that a reasonable balance is achieved by allowing completed construction or rehabilitation to be refinanced with insured mortgage proceeds if the work was completed more than 2 years before application. The cost of work completed less than 2 years before application could be refinanced only with a regulatory waiver on a case-by-case basis.

Therefore, this final rule substantially revises § 242.45 to provide for early commencement upon a minimal application and assurance. The final rule also provides for the refinancing opportunity for work completed more than 2 years prior to the application.

2. Section 242.47 Insured Advances for Building Components Stored Off-Site

Comment: One commenter states that § 242.47(b)(3) should be revised as follows:

> Storage costs, if any, shall be borne by the contractor (which shall include a construction manager).

Response: HUD does not believe that this provision should be limited to the construction manager form of construction, but rather that it should apply generally.

Comment: Section 242.47(d)(1)(ii) should be revised to provide that the mortgagee ''or its counsel'' may make the warranty regarding the security instruments.

Response: This final rule does not adopt this comment. Historically, HUD has required such warranties to be made by the mortgagee itself, since HUD's contractual relationship is directly with the mortgagee. The representation is made by the mortgagee in the mortgagee's certificate.

Comment: In the last sentence of § 242.47(d)(4), the phrase ''insurance of components'' should be revised to ''insurance of advances for components.''

Response: HUD agrees with the change suggested by the comment, because the resulting language is more precise.

3. Section 242.49 Funds and Finances: Deposits and Letters of Credit

Comment: One commenter states that this section should be revised, as indicated:

> (a) Deposits. Where HUD requires the mortgagor to make a deposit of cash or securities, such deposit (other than the Mortgage Reserve Fund or other funds held for the benefit of HUD) shall be with the mortgagee or a depository acceptable to the mortgagee. The deposit shall be held by or for the benefit of the mortgagee in a special account or by the depository under an appropriate agreement approved by HUD.
>
> (b) Letter of credit or surety bond. Where the use of a letter of credit or surety bond is acceptable to HUD in lieu of a deposit of cash or securities, the letter of credit shall be issued to the mortgagee by a banking institution with a National Rating Agency acceptable to HUD in the BBB category or its industry equivalent or equivalent or by another entity acceptable to HUD and shall be unconditional and irrevocable and a surety bond shall be issued to the mortgagee by an insurance company with the rating of a National Rating Agency acceptable to HUD in the BBB category or its industry equivalent. The mortgagee shall be responsible to HUD for collection under the letter of credit or surety bond.
>
> (c) Mortgagee not issuer. The mortgagee of record, unless a trustee in connection with bonds issued to fund the FHA mortgage loan, may not be the issuer of the letter of credit without the prior written consent of HUD.

The commenter's suggestion of a letter of credit option is in accordance with the comment to § 242.23. The commenter stated that the surety bond option would ''represent an opportunity for institutions to fund equity at more competitive costs.''

The commenter suggested revision to the allowed rating agencies because there are other rating agencies. The commenter mentioned two other national rating agencies specifically, and stated that there may be other acceptable ones. Moreover, the commenter stated, requiring an AA rating may limit the availability and increase the cost of credit facilities. The commenter stated that FHA recently amended its Section 232 liability

insurance requirements to permit a rating in the AM Best (a liability insurance company rating agency) B++ category. The commenter suggested that analogous criteria could be applied in this instance.

The commenter stated that the proposed requirement to ''immediately'' meet a demand for payment is troublesome, and that such an immediate timeframe has not been previously established for this purpose. The commenter stated that HUD should consider a reasonable timeframe, for example, that the funds are available when needed for the intended purposes.

Response: HUD agrees with the concept of including more explanatory language about the mortgagor's deposit in 242.49(a), but this final rule adopts slightly different language, which HUD believes is more accurate than the language suggested by the comment.

In response to comments to § 242.23(c), HUD stated that surety bonds are not an acceptable form of equity, and do not offer the level of protection the Department considers necessary. For this reason, the commenter's suggestion to allow the use of surety bonds in 242.49(b) is not accepted in this final rule.

The commenter also suggested changing the allowable credit quality of an acceptable letter of credit provider to B++. Because of the multiplicity of entities that provide ratings and the lack of uniformity among them, HUD has decided to provide in the rule that the lender can choose a financial institution acceptable to it. The lender is responsible for ensuring that any letter of credit is tantamount to cash. HUD has revised § 242.49(b) accordingly.

The commenter also suggested deleting the last sentence of § 242.49(b). HUD views the letter of credit the same as cash, and believes that the lender must have cash available when cash is necessary, so the final rule retains the proposed rule language.

4. Section 242.50 Funds and Finances: Off-Site Utilities and Streets

Comment: This section should be revised to allow the cash escrow to be in the form of a letter of credit or surety bond. The commenter also stated that ''the application of the sentence beginning 'Where such assurance' seems unclear. If mortgage proceeds are to be retained for these purposes without an offsetting cash or cash equivalent deposit with mortgagee at closing, in certain (e.g. where a mortgagor failed to provide needed cash at a later date), there would not be enough funds to complete the FHA project (sic).''

Response: With respect to surety bonds, HUD does not believe that surety bonds provide adequate protection (see also response to comment to § 242.23). For clarity, § 242.50 has been modified to specify that there must be adequate funds available to cover cost of off-site utilities and streets regardless of whether the funds come from escrow or mortgage proceeds for land, or both.

5. Section 242.51 Funds and Finances: Insured Advances and Assurances of Completion

Comment: Section 242.51(a) should be revised, as indicated:

> Where the estimated cost of construction, expansion or rehabilitation is more than $500,000, the mortgagor shall furnish assurance of completion in the form of corporate surety bonds for payment and performance, each in the minimum amount of 100 percent of the construction contract or Guaranteed Maximum Price in the case of construction management satisfactory to HUD and consistent with assurances permitted in connection with multifamily housing projects.

Response: The first sentence is changed to ''* * * cost of construction or substantial rehabilitation * * *'' because expansion is included in the term ''substantial rehabilitation'' as defined in § 242.1 in this final rule. The substance of the additional suggested change has been incorporated into the revised language in this final rule.

6. Section 242.53 Ineligible Contractors

Comment: Section 242.53(b), which prohibits identity of interest contracts, should be deleted, because identity-of-interest construction contracts are generally permitted in FHA multifamily programs so long as the contract is based on cost-plus, cost-certified methodology. Although this is an unlikely scenario in the Section 242 program, the structure should nevertheless be permitted.

Response: HUD believes allowing identity-of-interest projects would introduce unnecessary risks.

Comment: One commenter states that § 242.53(c) should be revised to remove the provision that allows HUD to refuse to insure advances, as well as make a conforming change by deleting the cross-reference to paragraph (b) of that section.

The commenter states that, although it agrees that FHA should have recourse in the event of inappropriate contracting, the list of eligible contractors is maintained and established by the federal government and not by mortgagors or lenders. Moreover, as part of the application process, FHA can screen contractors for these purposes before initial endorsement. As such, a remedy involving a refusal to insure further advances after endorsement not only appears unnecessary, but worse still, may precipitate extremely undesirable results and possibly jeopardize the completion of the project and the availability of secondary financing that provides the source of construction funds.

A still more serious problem would result if under these circumstances the mortgagee's funding obligation under the related Building Loan Agreement were not also terminated with FHA consent; otherwise, the mortgagee would continue to have a funding obligation under the governing Building Loan Agreement, but no ability to fund the loan. In other words, if FHA were to exercise this type of privilege, FHA would most likely have to agree to process an insurance claim if insured advances were withheld by FHA.

The termination of advances would be particularly problematic in cases financed with tax-exempt revenue bonds, the proceeds of which must be invested at initial endorsement so as to keep the bonds fully current until monies are disbursed through the FHA mortgage, and interest accruing on the mortgage is thereupon due for these purposes. Delays in disbursement could result in potential bond defaults and certainly impact the costs of financing. Because agencies of the federal government establish and maintain the list of ineligible contractors and review and approve construction contracts and contractor eligibility as part of the application process, any FHA remedies in this instance should be structured to avoid harm to mortgagors, lenders, or the project involved.

Response: HUD agrees with the commenter's concern. In order to provide for the completion of projects and to protect the insurance fund, proposed § 242.53(c) has been revised in this final rule to provide for remedial and enforcement actions other than refusing to insure further advances.

Subpart F—Nondiscrimination and Wage Rates

1. Section 242.54 Nondiscrimination

Comment: The provisions on sex and age discrimination should be removed because women and children's hospitals are eligible for federal and state reimbursement; however, the reference to ''sex'' and ''age'' in the regulation, absent clarification, may preclude such facilities from being eligible under this program.

Response: The provisions on civil rights are required by federal law and cannot be removed from the rule. HUD is revising § 242.54 in this final rule to clarify that the section does not affect the eligibility of women's and children's hospitals for this program.

Subpart G—Regulatory Agreement, Accounting and Reporting, and Financial Requirements

1. Section 242.56 Form of Regulation

Comment: The term ''mortgagor'' in the third sentence should be revised as ''mortgagor'' (and/or its lessee, if any) where it occurs:

* * * The mortgagor (and/or its lessee, if any) shall be subject to monitoring by HUD and the U.S. Department of Health and Human Services, and their agents, employees, and contractors, on an ongoing basis for the life of the insured mortgage to ensure against the risk of default, and the mortgagor (and/or its lessee, if any) must make its financial records available to the monitoring agencies upon request.

This suggestion is in accordance with similar comments made with respect to the definition of ''regulatory agreement'' and § 242.10.

Response: As discussed in the response to the comment to § 242.10, HUD will consider a lease in the rare instances when it is made necessary by state or local law. However, HUD does not consider this situation common enough to require specific regulatory language in the final rule. No addition of language to include lessees will be made. This final rule makes a technical correction to the last sentence to clarify that monitoring may be conducted by various agents and contractors on HUD's behalf.

2. Section 242.57 Maintenance of Hospital Facility

Comment: The section should be revised to add lessees, as follows:

The mortgagor (and/or its lessee, if any) shall maintain the hospital's grounds and buildings and the equipment financed with mortgage proceeds in good repair and shall promptly complete such repairs and maintenance as HUD considers necessary.

Response: The final rule does not add language regarding lessees for the reason stated in the response to comments on § 242.56.

3. Section 242.58 Books, Accounts, and Financial Statements

Comment: The section should be revised throughout to include mortgagors ''and/or their lessees, if any.''

Response: The final rule does not add language regarding lessees for the reason stated in the response to comments on §§ 242.10 and 242.56.

Comment: Proposed § 242.58(b)(ii) should be revised, as follows:

(ii) Quarterly unaudited financial reports, within 60 days following the end of each quarter of the mortgagor's (and/or its lessee, if any) fiscal year if requested by HUD.

Response: In HUD's experience, 40 days is sufficient time for mortgagors to prepare, review, and submit interim financial statements.

Comment: Proposed § 242.58(b)(iv) should be revised to make the board-certified financial results due within 180 days following the close of the fiscal year, rather than 120 days.

Response: In HUD's experience, 120 days is a sufficient time frame.

Comment: Proposed § 242.58(f) should be revised where it requires books and records to be maintained in accordance with Generally Accepted Accounting Principles (GAAP) to allow flexibility. In the first sentence, the commenter would add the following phrase after ''(GAAP)'': ''* * * or such other accounting principles as may be customary for such persons and acceptable to HUD.'' Some managers and public facilities may use different accounting rules.

Response: Some governmental hospitals use accounting rules under Governmental Accounting Standards. Therefore, the final rule permits the use of Governmental Accounting Standards.

Comment: The regulatory agreement provides: ''If the Mortgagor has any business or activity other than the project and operation of the mortgaged property, it shall maintain all income and other funds of the project segregated from any other funds of the mortgagor and segregated from any funds of any other corporation or persons.'' This requirement does not appear in the proposed regulation. The commenter asked whether this omission is a change in policy.

Response: This requirement is included in the regulatory agreement, and is therefore legally effective and binding on program participants. Participants in HUD's programs are expected to comply with regulatory agreements and contracts pertinent to the programs in which they participate, as well as with program rules. There is no change in policy as to the requirement of segregation of funds.

4. Section 242.61 Management

Comment: Proposed § 242.61(a) should be revised to eliminate the provision for termination without cause and substitute in its place a requirement that termination be for cause and without penalty. The ''without cause'' provision would result in fewer qualified companies being willing to make the investment required to undertake the management of a project. Second, management fees in view of the uncertainties of termination without cause would likely be significantly higher than otherwise. There would seem to be no legitimate policy objective to justify a termination without cause in such instances.

Also, the commenter states that it will be difficult if not impossible for FHA to be given the right to terminate existing agreements (often on a multi-year basis) in place prior to initial endorsement.

Response: In the past, this clause has served the program well and HUD has received no indications that management companies are less willing to manage a hospital, nor that management fees are increased as a result of this clause. HUD needs to be in a position to move quickly and decisively. For agreements existing at the time of commitment, HUD does not require termination but does require an amendment to permit termination by HUD with or without cause.

Comment: The introductory paragraph of § 242.61 and §§ 242.61(a) and 242.61(b) should be revised to include lessees of mortgagors, in accordance with other similar comments.

Response: As discussed in the response to the comment in § 242.10 and other similar comments, HUD will consider leases in the rare instances in which local law makes them necessary; however, this situation is not common enough to merit inclusion in the final rule.

Comment: The section should be clarified to apply to a management agreement executed in connection with an entire facility and not specified services such as pharmacy, cafeteria, or laundry.

Response: HUD believes the language ''for management of the hospital'' is clear and would not preclude contracts for management of ancillary services such as pharmacy, cafeteria, or laundry.

Comment: The term ''principals'' used in § 242.61(b) should be defined. In the case of proprietary mortgagors, the term should not include shareholders.

Response: 24 CFR 24.995 defines ''principal'' and the term is also well understood in the mortgage insurance industry. No additional definition is required.

5. Section 242.62 Releases of Lien

Comment: The first sentence of § 242.62 should be revised as shown below, and the second sentence, dealing

with partial releases of lien, should be deleted:

> The mortgagor shall not sell, dispose of, transfer, or permit to be encumbered any security property without the prior approval of the lender and Commissioner, subject to thresholds or such other standards HUD may establish for the approval requirement.

The commenter states that the determination required for partial releases of liens should be made by HUD, which was responsible for the original determination for these purposes in the pre-commitment process, as lenders, particularly bond trustees or lenders by assignment and not involved in loan origination, will more than likely lack the expertise for these purposes.

Response: The words ''or such other standards'' have been added, as suggested. With respect to the second point on partial releases, HUD believes that the lender should have the capability to make this decision, subject to prior approval by HUD.

6. Section 242.63 Additional Indebtedness and Leasing

Comment: This section should be revised to include the mortgagor's lessees, in accordance with other similar comments.

Response: HUD does not believe lease situations warrant inclusion in the final rule. See previous response to comments on §§ 242.10 and 242.56.

7. Section 242.64 Current and Future Property

Comment: The requirement that ''all current or future property or personalty * * * on or off the mortgaged real estate * * * will be considered as part of the HUD-insured hospital and subject to all provisions of the HUD regulatory agreement'' is ''troublesome'' and should be reconsidered. In many instances, this requirement precludes a hospital from making timely business decisions and arranging for financing with respect to acquisitions or off-site properties that might complement the business plan of the FHA facility, particularly given the timeframe sometimes required to obtain required FHA approval. Hospitals, for example, frequently purchase residential space for nurses and doctors and frequently purchase office buildings in peripheral areas to maintain market share and the like. Future purchases for these purposes and the ability to mortgage such ventures should be permitted.

Flexibility should be included in this requirement. While this requirement is appropriate for on-site property, when off the mortgage site and independent of hospital operations, the requirement is more problematic and should be eliminated or, alternatively, made subject to particular pre-determined financial ratios or standards for release that would allow a transaction to move forward without additional FHA consent.

Response: Even though hospitals meeting particular economic thresholds have the power under the regulatory agreement and covenants to acquire and transfer particular property without the prior written approval of HUD, the regulation does clearly and properly indicate that HUD will regulate the operation of the hospital and will not permit hospitals to acquire property that is crucial to the operation of the hospital, but to which the lender and/or HUD would not have access in the event of default and foreclosure. Therefore, there is no change to the final rule as a result of this comment.

Comment: The last sentence of this paragraph should be revised to allow HUD's first lien to be subordinated as acceptable to HUD. Other provisions of these regulations permit exceptions to FHA's first lien requirement based on Commissioner discretion. The requirement in this sentence should parallel those provisions.

Response: It is not legally possible for HUD to subordinate its first lien position on a § 242 mortgage. Section 242(b)(2) of the Act, 12 U.S.C. 1715z–7(b)(2), states that ''mortgage'' shall have the meaning stated in 12 U.S.C. 1713(a). That section defines ''mortgage'' as ''a first mortgage on real estate in fee simple.'' Therefore, HUD must have a first lien position on hospital mortgages under this program. For clarity, the wording of the first sentence of § 242.64 has been slightly revised.

8. Section 242.66 Affiliate Transactions

Comment: The phrase ''with affiliates'' should be added at the beginning of the first sentence after ''Transactions.''

Response: HUD agrees with the suggested change, as it clarifies the meaning. Also, the last phrase, ''in accordance with such policies and procedures as HUD shall prescribe,'' is removed in this final rule as superfluous.

Subpart H—Miscellaneous Requirements

1. Section 242.68 Disclosure and Verification of Social Security and Employer Identification Numbers

Comment: The word ''applicants'' should be deleted and ''mortgagors'' used instead.

Response: While a similar change has been made elsewhere in the rule, in this section it is inappropriate. The language being referenced specifically quotes the requirements of 24 CFR 5.210 *et seq.*, which refers to ''applicants for and participants in'' covered programs, rather than mortgagors. This final rule revises § 242.68 slightly to make this usage clear.

2. Section 242.72 Leasing of Hospital

Comment: One commenter states that this section should be revised to permit leasing of an entire hospital, including lease-back transactions, with HUD's consent. The specific language would be as follows:

> Leasing of a hospital in its entirety is prohibited without Commissioner consent. Notwithstanding this prohibition, any proposal in which leasing (and related subleasing back to lessor, or transactions of a similar nature) of the entire facility is a factor due to State, county or other governmental law prohibitions against the mortgaging of health care facilities by such State, county or other governmental entities shall be considered on a case-by-case basis. Also, leasing of a hospital that has an existing Section 242 insured loan is permitted if HUD determines that leasing is necessary to reduce the risk of default by a financially troubled hospital.

The commenter states that the prohibition of operator lessees, with the exception of publicly owned entities, should be eliminated, and the eligibility of projects with operating leases should be permitted for all forms of sponsorship on a case-by-case basis, whether nonprofit, public, or proprietary owners. Language that precludes nonprofit and proprietary sponsors from utilizing an operating lease approach, particularly when that arrangement has legitimate functional advantages and the proposed project otherwise complies with FHA financial standards, discriminates against these other forms of ownership and is inconsistent with statutory policy that permits financing for each of these ownership forms. The commenter states that operator lease arrangements have been routinely permitted in the case of proprietary and nonprofit sponsors in the Section 232 program and that there is no public policy served by a prohibition against these types of sponsors when the public interest can be protected and an operator properly regulated by FHA.

Response: See responses to comments on § 242.10 and § 242.56.

3. Section 242.74 Smoke Detectors

Comment: This section should be removed because not only may the rule conflict with state or local requirements,

but because the specific requirement may be superseded by evolving technology or law.

Response: The section is amended to read:

Each occupied room must include such smoke detectors as are required by law.

4. Section 242.75 Title Requirements

Comment: This section should be revised as follows, in accordance with comment to § 242.72 above to permit hospital leaseholds.

In order for the mortgaged property, including leasehold estates, to be eligible for insurance, HUD shall determine that marketable title thereto is vested in the mortgagor, lessee, or lessor, as appropriate, as of the date the mortgage is filed for record. The title evidence shall be examined by HUD and the endorsement of the credit instrument for insurance shall be evidence of its acceptability.

Response: HUD does not adopt this comment in the final rule for the reasons stated in response to comments on §§ 242.10 and 242.56.

5. Section 242.76 Title Evidence

Comment: The second sentence of § 242.76(a) should be revised to read:

The policy shall name as the insureds the mortgagee and the Secretary of Housing and Urban Development, their successors and assigns, as their respective interests may appear.

Response: The final rule adds ''successors and assigns,'' as suggested.

6. Section 242.77 Liens

Comment: One commenter stated that § 242.77(a) should be revised to allow parity liens, as follows:

An inferior or parity lien made or held by a Federal, State, or local government instrumentality;

The commenter stated that such liens have been approved in at least two cases, one involving another federal agency, the former federal Farmers Home Loan Administration, with the other involving another FHA loan, and that flexibility for such limited purposes should be provided.

Response: HUD has no statutory authority to insure loans that are on a parity basis with other loans.

Comment: Section 242.77(b) should be revised, as follows:

An inferior lien required in connection with a supplemental loan insured pursuant to section 241 or Section 223(a)(7) of the Act;

Response: HUD disagrees with the comment. Including § 223(a)(7) would be confusing because these financings must have first liens, with the exception of those made pursuant to Section 241 loans.

Comment: Section 242.77(c) should be revised to incorporate state law considerations, as follows:

An inferior or superior lien on equipment as may be approved in connection with an equipment leasing program approved by HUD, as required by governing state law, in connection with existing financed equipment at the time of initial endorsement or as may or as otherwise may be approved by HUD.

The commenter states that in New York, for example, as a matter of law, equipment purchased pursuant to a lease-purchase or purchase money arrangement will be superior to the insured mortgage, albeit upon the payoff of the underlying financing, the equipment could be covered by the FHA lien instruments.

Response: HUD believes this section is sufficiently flexible, as written.

7. Section 242.89 Supplemental Loans

Comment: This section should be revised to include refinancing of indebtedness resulting from the early start of construction:

A loan, advance of credit, or purchase of an obligation representing a loan or advance of credit made for the purpose of financing improvements or additions (including the refinancing of any indebtedness incurred in connection with the early start of construction of such improvements or additions) to a hospital covered by a mortgage insured under this section of the Act or for a Commissioner-held mortgage, or equipment for a hospital, may be insured pursuant to the provisions of section 241 of the Act and under the provisions of this part as applicable and such additional terms and conditions as established by HUD. See subpart B of 24 CFR part 241 with respect to the contract of mortgage insurance for all loans insured under section 241 of the Act. See 24 CFR part 241, subpart C, for energy improvements.

Response: In order to make this section consistent with the final rule provisions on early commencement of work and refinancing of indebtedness, HUD has added the suggested parenthetical phrase with modification: ''(including the refinancing of any indebtedness incurred in connection with the early commencement of work on such improvements or additions, subject to the requirements of §§ 242.15 and 242.45).''

8. Section 242.91 Eligibility of Refinancing Transactions

Comment: The discussion in § 242.91(c) is confusing regarding the term length of a section 223(a)(7) loan. It appears from the reading that in particular cases, the term could be 35 years if the current mortgage has 23 years remaining, plus the additional 12 years.

Response: HUD has determined that the language should remain unchanged. HUD may approve a term up to 12 years beyond the remaining term of the existing mortgage if it is determined that the longer term is necessary to ensure the economic viability of the hospital and to make an insurance claim less likely.

Findings and Certifications

Information Collection Requirements

The information collection requirements contained in §§ 242.16, 242.35, 242.58, 242.61, and 242.68 have been approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) and assigned OMB Control Number 2502–0518. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless the collection displays a currently valid control number.

Environmental Impact

A Finding of No Significant Impact with respect to the environment for this final rule was made at the proposed rule stage in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)). The Finding of No Significant Impact remains applicable, and is available for public inspection between 8 a.m. and 5 p.m. weekdays in the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 Seventh Street, SW., Room 10276, Washington, DC 20410–5000.

Unfunded Mandates Reform Act

The Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments and on the private sector. This rule does not impose a federal mandate on any state, local, or tribal government, or on the private sector, within the meaning of UMRA.

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 *et seq.*), generally requires an agency to conduct a regulatory flexibility analysis of any rule subject to notice and comment rulemaking requirements, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.

There are no anti-competitive discriminatory aspects of the rule with

regard to small entities, and there are not any unusual procedures that would need to be complied with by small entities. The rule revises the regulations under the mortgage insurance program for hospitals to update and improve the efficiency of the program.

Therefore, this final rule will not have a significant economic impact on a substantial number of small entities, and an initial regulatory flexibility analysis is not required.

Executive Order 13132, Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on state and local governments and is not required by statute, or the rule preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments nor preempt state law within the meaning of the Executive Order.

Regulatory Planning and Review

OMB reviewed this rule under Executive Order 12866, Regulatory Planning and Review. OMB determined that this rule is a ''significant regulatory action,'' as defined in section 3(f) of the order (although not an economically significant regulatory action under the order). The docket file is available for public inspection in the Regulations Division, Office of General Counsel, 451 Seventh Street, SW., Room 10276, Washington, DC 20410–0500.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance number is 14.128.

List of Subjects

24 CFR Part 200

Administrative practice and procedure, Claims, Equal employment opportunity, Fair housing, Home improvement, Housing standards, Lead poisoning, Loan programs—housing and community development, Mortgage insurance, Organization and functions (Government agencies), Penalties, Reporting and recordkeeping requirements, Social Security, Unemployment compensation, Wages.

24 CFR Part 242

Hospitals, Mortgage insurance, Reporting and recordkeeping requirements.

■ Accordingly, for the reasons described in the preamble, HUD amends 24 CFR parts 200 and 242 to read as follows:

PART 200—INTRODUCTION TO FHA PROGRAMS

■ 1. The authority citation for part 200 continues to read as follows:

Authority: 12 U.S.C. 1702–1715z–21; 42 U.S.C. 3535(d).

■ 2. Section 200.24 is revised to read as follows:

§ 200.24 Existing projects.

A mortgage financing the purchase or refinance of an existing rental housing project under section 207 of the Act, or for refinancing the existing debt of an existing nursing home, intermediate care facility, assisted living facility, or board and care home, or any combination thereof, under section 232 of the Act, may be insured pursuant to provisions of section 223(f) of the Act and such terms and conditions established by HUD.

■ 3. Section 200.25 is revised to read as follows:

§ 200.25 Supplemental loans.

A loan, advance of credit or purchase of an obligation representing a loan or advance of credit made for the purpose of financing improvements or additions to a project covered by a mortgage insured under any section of the Act or Commissioner-held mortgage, or equipment for a nursing home, intermediate care facility, board and care home, assisted living facility, or group practices facility, may be insured pursuant to the provisions of section 241 of the Act and such terms and conditions established by HUD.

■ 4. 24 CFR 200.40 is amended by revising paragraphs (c), (d), and (f) as follows:

§ 200.40 HUD fees.

* * * * *

(c) *Application fee—conditional commitment.* For a mortgage being insured under section 223(f) of the Act (12 U.S.C. 1715n), an application-commitment fee of $3 per thousand dollars of the requested mortgage amount shall accompany an application for conditional commitment.

(d) *Application fee—firm commitment: General.* An application for firm commitment shall be accompanied by an application-commitment fee which, when added to any prior fees received in connection with applications for a SAMA letter or a feasibility letter, will aggregate $5 per thousand dollars of the requested mortgage amount to be insured. The payment of an application-commitment fee shall not be required in connection with an insured mortgage involving the sale by the government of housing or property acquired, held, or contracted pursuant to the Atomic Energy Community Act of 1955 (42 U.S.C. 2301 *et seq.*).

* * * * *

(f) *Fees on increases—in general.* This section applies to all applications except applications involving hospitals, which are covered in 24 CFR part 242.

(1) *Increase in firm commitment before endorsement.* An application, filed before initial endorsement (or before endorsement in a case involving insurance upon completion), for an increase in the amount of an outstanding firm commitment, shall be accompanied by a combined additional application and commitment fee. This combined additional fee shall be in an amount that will aggregate $5 per thousand dollars of the amount of the requested increase. If an inspection fee was required in the original commitment, an additional inspection fee shall be paid in an amount computed at the same dollar rate per thousand dollars of the amount of increase in commitment as was used for the inspection fee required in the original commitment. When insurance of advances is involved, the additional inspection fee shall be paid at the time of initial endorsement. When insurance upon completion is involved, the additional inspection fee shall be paid before the date construction is begun; or, if construction has begun, it shall be paid with the application for increase.

(2) *Increase in mortgage between initial and final endorsement.* Upon the filing of an application between initial and final endorsement, for an increase in the amount of the mortgage, either by amendment or by substitution of a new mortgage, a combined additional application and commitment fee shall accompany the application. This combined additional fee shall be in an amount that will aggregate $5 per thousand dollars of the amount of the increase requested. If an inspection fee was required in the original commitment, an additional inspection fee shall accompany the application in an amount not to exceed the $5 per thousand dollars of the amount of the increase requested.

(3) *Loan to cover operating losses.* In connection with a loan to cover operating losses (see Sec. 200.22), a combined application and commitment fee of $5 per thousand dollars of the amount of the loan applied for shall be

submitted with the application for a firm commitment. No inspection fee shall be required.

* * * * *

■ 5. Part 242 is revised to read as follows:

PART 242—MORTGAGE INSURANCE FOR HOSPITALS

Subpart A—General Eligibility Requirements

Subpart B—Application Procedures and Commitments

Subpart C—Mortgage Requirements

Subpart D—Endorsement for Insurance

Subpart E—Construction

Subpart F—Nondiscrimination and Wage Rates

Subpart G—Regulatory Agreement, Accounting and Reporting, and Financial Requirements

Subpart H—Miscellaneous Requirements

Authority: 12 U.S.C. 1709, 1710, 1715b, and 1715u; 42 U.S.C. 3535(d).

Subpart A—General Eligibility Requirements

§ 242.1 Definitions.

As used in this subpart, the following terms shall have the meaning indicated:

Act means the National Housing Act (12 U.S.C. 1701 *et seq.*).

Affiliate means a person or entity which, directly or indirectly, either controls or has the power to control or exert significant influence on the other, or a person and entity both controlled by a third person or entity, which may be a parent entity. Indicia of control include, but are not limited to: Interlocking management or ownership, identity of interests among family members, shared facilities and equipment, common use of employees, or a business entity organized following the suspension or debarment of a person or entity that has the same or similar management, ownership, or principal employees as the suspended, debarred, ineligible, or voluntarily excluded person or entity or as defined in the Medicare reimbursement regulations.

AMPO (Allowance for Making Project Operational) relates to nonprofit projects and means a fund that is primarily for accruals during the course of construction for mortgage insurance premiums (MIPs), taxes, ground rents, property insurance premiums, and assessments, when funds available for these purposes under the Building Loan Agreement have been exhausted; and also for allocation to such accruals after completion of construction, if the income from the hospital at that time is insufficient to meet such accruals. AMPO may also be used for such other purposes as approved by HUD. Any balance remaining unused in the fund at final endorsement will be treated in accordance with § 242.43.

Applicant means a HUD multifamily-approved lender that would be the mortgagee of record.

Chronic convalescent and rest means skilled nursing services, intermediate care services, respite care services, hospice services, rehabilitation services, and other services of a similar nature.

Construction means the creation of a new or replacement hospital facility, which may include the cost of acquisition of new or replacement equipment in the cost of construction.

Days of cash on hand means the number of days of operating cash available to the hospital, calculated pursuant to standards determined by HUD.

Debt service coverage ratio is a measure of a hospital's ability to pay interest and principal with cash generated from current operations. Debt service ratio is calculated as follows: Debt Service Coverage Ratio (total debt service coverage on all long-term capital debt) equals the excess of revenues over expenses (not-for-profit) or net income (for-profit) plus interest expense plus

depreciation expense plus amortization expense, all divided by current portion of long-term debt (including capital leases) from the previous year's audited financial statement plus interest expense. The calculation can be expressed as:

$$\frac{(\text{Excess of revenues over expenses OR net income}) + \text{interest expense} + \text{depreciation expense} + \text{amortization expense}}{\text{Current portion of long-term debt [prior year, including capital leases]} + \text{interest expense}}$$

Hospital means a facility that has been proposed for approval or has been approved by HUD under the provisions of this subpart, and:

(1) That provides community services for inpatient medical care of the sick or injured (including obstetrical care);

(2) Where not more than 50 percent of the total patient days during any year are customarily assignable to the categories of chronic convalescent and rest, drug and alcoholic, epileptic, mentally deficient, mental, nervous and mental, and tuberculosis, except that the 50 percent patient day restriction does not apply to Critical Access Hospitals (hospitals designated as such under the Medicare Rural Hospital Flexibility Program) between January 28, 2008 and July 31, 2011.

(3) That is a facility licensed or regulated by the state (or, if there is no such state law providing for such licensing or regulation by the state, by the municipality or other political subdivision in which the facility is located) and is:

(i) A public facility owned by a state or unit of local government or by an instrumentality thereof, or owned by a public benefit corporation established by a state or unit of local government or by an instrumentality thereof;

(ii) A proprietary facility; or

(iii) A facility of a private nonprofit corporation or association.

Identity of interest means a relationship that must be disclosed and may be prohibited pursuant to the requirements of the Regulatory Agreement. Examples of a prohibited Identity of Interest relationship are, but are not limited to, a financial or family relationship between the mortgagor (which includes but is not limited to an officer, director, or partner of the mortgagor) and general contractor, subcontractor, seller of the land or property, any consultants, or other parties to the transaction.

Mortgage means such classes of first liens as are commonly given to secure advances on, or the unpaid purchase price of, real estate under the laws of the state in which the real estate is located, together with any mortgage note secured thereby. The mortgage may be in the form of one or more trust mortgages or mortgage indentures or deeds of trust securing notes, bonds, or other mortgage notes; and, by the same instrument or by a separate instrument, it may create a security interest in the personalty, including, but not limited to, the equipment, whether or not the equipment is attached to the realty, and in the revenues and receivables of the hospital.

Mortgagee or lender means the original lender under a mortgage, and its successors and assigns, including the holders of mortgage notes issued under a trust mortgage or deed of trust pursuant to which such holders act by and through a trustee therein named. (All official contacts and actions by HUD shall be with or through a HUD-approved lender.)

Mortgagor means the original borrower under a mortgage and its successors and assigns.

Mortgage Reserve Fund means a trust account, or an account held by the mortgagee, for and on behalf of the mortgagor, to which the mortgagor contributes and from which withdrawals must be approved by HUD. The purpose of the fund is to provide HUD a means to assist the hospital to avoid mortgage defaults and to preserve the value of the mortgaged property and the hospital's business.

Most recent audited financial statement means the audited financial statement required under the regulatory agreement for the prior fiscal year.

Net income means the net income of a for-profit entity, or, in the case of a nonprofit entity, the excess of revenues less expenses.

Non-operating revenues and expenses are those revenues and expenses not directly related to patient care, hospital-related patient services, or the sale of hospital-related goods. Examples of items classified as non-operating are state and federal income tax, general contributions, gains and losses from investments, unrestricted income from endowment funds, and income from related entities.

Classification of items as operating or non-operating shall follow written guidance by HUD.

Operating margin is operating income divided by operating revenue, where:

(1) *Operating revenue* is the revenue from the core patient care operations of the hospital. It includes revenues from the provision of such items as patient care (including, but not limited to, hospital-based nursing home and physicians' clinics); transfers from temporarily restricted accounts that are used for current operating expenses; and patient-related activities such as the operation of the cafeteria, parking facilities, television services to patients, sale of medical scrap or waste, etc. (Additional sources of revenue, which are classified as non-operating, are excluded from this measure, provided, however, at HUD's discretion, that revenue that has historically been received reliably and is expected to continue to be received may be considered operating revenue for underwriting purposes); and

(2) *Operating income* is operating revenue minus operating expenses, where operating expenses are the expenses incurred in providing patient care, including such items as salaries, supplies, and the cost of capital.

Parent means an organization or entity that controls or has a controlling interest in another organization or entity.

Personalty means all furniture, furnishings, equipment, machinery, building materials, appliances, goods, supplies, tools, books, records (whether in written or electronic form), computer equipment (hardware and software) and other tangible or electronically stored personal property (other than fixtures) that are owned or leased by the borrower or the lessee now or in the future in connection with the ownership, management, or operation of the land or the improvements or are located on the land or in the improvements, and any operating agreements relating to the land or the improvements, and any surveys, plans, specifications, and contracts for architectural, engineering, and construction services relating to the land or the improvements, chooses in action and all other intangible property and rights relating to the operation of, or used in connection with, the land or the improvements, including all governmental permits relating to any activities on the land. Personalty also includes all tangible and intangible personal property used for health care

(such as major movable equipment and systems), accounts, licenses, bed authorities, certificates of need required to operate the hospital and to receive benefits and reimbursements under provider agreements with Medicaid, Medicare, state and local programs, payments from health care insurers and any other assistance providers (''Receivables''); all permits, instruments, rents, lease and contract rights, and equipment leases relating to the use, operation, maintenance, repair, and improvement of the hospital. Generally, intangibles shall also include all cash and cash escrow funds, such as but not limited to: Depreciation reserve fund or mortgage reserve fund accounts, bank accounts, residual receipt accounts, all contributions, donations, gifts, grants, bequests, and endowment funds by donors, and all other revenues and accounts receivable from whatever source paid or payable. All personalty shall be securitized with appropriate UCC filings and any excluded personalty shall be indicated in the Regulatory Agreement.

Preapplication meeting means a meeting among HUD, a potential mortgagee (applicant), and a potential mortgagor for mortgage insurance where there has been a positive Preliminary Review of the proposed project. The preapplication meeting is an opportunity for the potential mortgagee and mortgagor to summarize the proposed project, for HUD to summarize the application process, and for issues that could affect the eligibility or underwriting of the proposed loan to be identified and discussed.

Preliminary Review Letter means a letter from HUD to a potential applicant communicating the result of the Preliminary Review. The letter may state that an application for mortgage insurance would probably not be successful and provide the reasons for this determination, or state that no factors that would cause an application to be rejected have been identified, and therefore there appears to be no bar to the applicant proceeding to a preapplication meeting.

Project means the construction (which may include replacement of an existing hospital facility) or substantial rehabilitation of an eligible hospital, including equipment, which has been proposed for approval or has been approved by HUD under the provisions of this subpart, including the financing and refinancing, if any, plus all related activities involved in completing the improvements to the property. However, in particular closing documents, ''project'' may be used to mean the mortgagor entity, the operation of the mortgagor, the facility, or all of the mortgaged property, depending on the context in which it is used.

Regulatory Agreement means the agreement under which all mortgagors shall be regulated by HUD, as long as HUD is the insurer or holder of the mortgage, in a published format determined by HUD, and such additional covenants and restrictions as may be determined necessary by HUD on a case-by-case basis.

Secretary means the Secretary of Housing and Urban Development or his or her authorized representatives.

Security instrument means a mortgage, deed of trust, and any other security for the indebtedness, and shall be deemed to be the mortgage as defined by the National Housing Act, as amended, implementing regulations, and HUD directives.

Service area means that geographical area, identified by zip codes, from which a substantial majority of a hospital's patients derive.

State includes the several states, Puerto Rico, the District of Columbia, Guam, the Trust Territory of the Pacific Islands, American Samoa, and the United States Virgin Islands.

Substantial rehabilitation means additions, expansion, remodeling, renovation, modernization, repair, and alteration of existing buildings, including acquisition of new or replacement equipment.

Surplus Cash means any cash earned in the applicable fiscal period, including accounts receivable and equity balance, remaining after all of the following conditions have been met:

(1) Final endorsement of the HUD-insured note has occurred;

(2) Mortgage payments for the preceding 12 months have been made when due, including any grace period;

(3) The Debt Service Coverage Ratio is greater than or equal to 1.50 in the most recent audited financial statements and as of the date of distribution;

(4) Days in Accounts Receivable are less than or equal to 80 in the most recent audited financial statements and as of the date of distribution;

(5) The average payment period is less than or equal to 80 in the most recent audited financial statements and as of the date of distribution;

(6) The Mortgage Reserve Fund (MRF) is fully funded as of the date of the distribution in conformity with the MRF schedule;

(7) All income, property, and statutory employer payroll taxes and employee payroll withholding contributions (including penalties and interest, if applicable) have been deposited as of the date of the distribution, as required;

(8) The Current Ratio is greater than or equal to 1.50 in the most recent audited financial statements and immediately after the distribution;

(9) Days of cash on hand are greater than or equal to 21 days in the most recent audited financial statements and immediately after the distribution;

(10) The distribution may not be more than 50 percent of Net Income as reflected in the most recent audited financial statements, unless the Mortgagor has an equity financing ratio equal to or greater than 20 percent in the most recent audited financial statements and immediately after the distribution; and

(11) The Equity less any assets excluded from the mortgaged property is greater than 0.00 in the most recent audited financial statements and immediately after the distribution is made. As used in this definition:

''Most recent audited financial statements'' refers to the audited financial statement required under section 242.58 for the prior fiscal year;

''Net Income'' means Net Income for for-profit entities; Excess of Revenues over Expenses for not-for-profit entities; and Excess of Revenues over Expenses before Capital Grants, Contributions, and Additions to Permanent Endowment for governmental entities; and

''Equity financing ratio'' means (Equity less any assets excluded from the mortgaged property)/(total assets less any assets excluded from the mortgaged property). Equity is defined as Equity for a for-profit entity, Total Net Assets for not-for-profit entities, and Total Net Assets for governmental entities.

§ 242.2 Program financial self-sufficiency.

The Commissioner shall administer the Section 242 program in such a way as to encourage financial self-sufficiency and actuarial soundness; i.e., to avoid mortgage defaults and claims for insurance benefits in order to protect the mortgage insurance fund.

§ 242.3 Encouragement of certain programs.

The activities and functions provided for in this part shall be carried out so as to encourage provision of comprehensive health care, including outpatient and preventive care as well as hospitalization, to a defined population, and in the case of public and certain not-for-profit hospitals, to encourage programs that are undertaken to provide essential health care services to all residents of a community regardless of ability to pay.

§ 242.4 Eligibility for insurance and transition provision.

(a) The hospital to be financed with a mortgage insured under this part shall involve the construction of a new hospital or the substantial rehabilitation (or replacement) of an existing hospital.

(b) This part applies only to applications for FHA mortgage insurance submitted after a pre-application meeting (as defined in § 242.1) with HUD that occurred on and after January 28, 2008. HUD's regulations and practices prior to January 28, 2008 apply to applications for FHA mortgage insurance submitted after a pre-application meeting that occurred before January 28, 2008.

§ 242.5 Eligible mortgagees/lenders.

The lender requirements set forth in 24 CFR part 202 regarding approval, recertification, withdrawal of approval, approval for servicing, report requirements, and conditions for supervised mortgagees, nonsupervised mortgagees, investing mortgagees, and governmental and similar institutions, apply to these programs.

§ 242.6 Property requirements.

The mortgage, to be eligible for insurance, shall be on property located in a state, as defined in § 242.1. The mortgage shall cover real estate in which the mortgagor has one of the following interests:

(a) A fee simple title;

(b) A lease for not less than 99 years that is renewable; or

(c) A lease having a term of not less than 50 years to run from the date the mortgage is executed.

§ 242.7 Maximum mortgage amounts.

The mortgage shall involve a principal obligation not in excess of 90 percent of HUD's estimate of the replacement cost of the hospital, including the equipment to be used in its operation when the proposed improvements are completed and the equipment is installed.

§ 242.8 Standards for licensure and methods of operation.

The Secretary shall require satisfactory evidence that the hospital will be located in a state or political subdivision of a state with reasonable minimum standards of licensure and methods of operation for hospitals, and satisfactory assurance that such standards will be applied and enforced with respect to the hospital.

§ 242.9 Physician ownership.

Ownership of an interest in the mortgagor by physicians or other professionals practicing in the hospital is permitted within limits determined by HUD to avoid insurance risks that may be associated with such ownership. The Commissioner shall determine if the proposed mortgagor will be at low risk for violation of regulations of the U.S. Department of Health and Human Services, other federal regulations, and state regulations governing kickbacks, self-referrals, and other issues that could increase the risk of eventual default. The Commissioner's determination shall be based on an unqualified legal opinion as to compliance with applicable federal law, among other considerations.

§ 242.10 Eligible mortgagors.

The mortgagor shall be a public mortgagor (i.e., an owner of a public facility), a private nonprofit corporation or association, or a profit-motivated mortgagor meeting the definition of ''hospital'' in § 242.1. The mortgagor shall be approved by HUD and shall possess the powers necessary and incidental to operating a hospital. Eligible proprietary or profit-motivated mortgagors may include for-profit corporations, limited partnerships, and limited liability corporations and companies, but may not include natural persons, joint ventures, and general partnerships. Any proposed mortgagor must demonstrate that it has a continuity of organization commensurate with the term of the mortgage loan being insured. For new organizations, or those whose continuity is necessarily dependent upon an individual or individuals, broad community participation is required.

§ 242.11 Regulatory compliance required.

An application for insurance of a mortgage under this part shall be considered only in connection with a hospital that is in substantial compliance with regulations of the Department of Health and Human Services and the regulations of the applicable state governing the operation and reimbursement of hospitals. A hospital that is under investigation by any state or federal agency for statutory or regulatory violations is not eligible so long as the investigation is unresolved, unless HUD determines that the investigation is minor in nature; that is, the investigation is unlikely to result in substantial liabilities or to otherwise substantially harm the creditworthiness of the hospital.

§ 242.13 Parents and affiliates.

As a condition of issuing a commitment, HUD may require corporate parents, affiliates, or principals of the proposed mortgagor to provide assurances, guarantees, or collateral to protect HUD's interests. The Commissioner may also require financial and operational information on the parent, other businesses owned by the parent, or affiliates of the proposed mortgagor and may also require a parent or affiliate to be regulated by HUD as to certain actions that could impact on the insurance of a mortgage loan for the benefit of the hospital.

§ 242.14 Mortgage reserve fund.

As a condition of issuing a commitment, HUD shall require establishment of a Mortgage Reserve Fund (MRF). The mortgagor shall be required to make contributions to the MRF such that, with fund earnings, the MRF will build to one year of debt service at 5 years following commencement of amortization, increasing thereafter to 2 years of debt service on and after 10 years following commencement of amortization according to a schedule established by HUD, unless HUD determines that a different schedule of contributions is appropriate based on the mortgagor's risk profile, reimbursement structure, or other characteristics. In particular, hospitals that receive cost-based reimbursement may be required to have MRFs that build to more than 2 years of debt service. Expenditures from the fund are made at HUD's sole discretion or in accordance with the mortgagor's MRF Schedule. Upon termination of insurance, the balance of the MRF shall be returned to the mortgagor, provided that all obligations to HUD have been met.

§ 242.15 Limitation on refinancing existing indebtedness.

Some existing capital debt may be refinanced with the proceeds of a section 242 insured loan; however, the hard costs of construction and equipment must represent at least 20 percent of the total mortgage amount.

Subpart B—Application Procedures and Commitments

§ 242.16 Applications.

(a) *Application process*—(1) *Market Need.* The approval process entails a determination of the market need of the proposal and stresses, on a market-wide basis, the impact of the proposed facility on, and its relationship to, other health care facilities and services (particularly other hospitals with mortgages insured under this part and hospitals that have a disproportionate share of Medicaid and uninsured patients or provide a substantial amount of charity care); the number and percentage of any excess

beds; and demographic projections. Generally, Section 242 insurance may support start-up hospitals or major expansions of existing hospitals only if existing hospital capacity or services are clearly not adequate to meet the needs of the population in the service area.

(i) If the state has an official procedure for determining need for hospitals, HUD shall require that such procedure be followed before the application for insurance is submitted, and that the application document that need has also been established under that procedure.

(ii) The following factors are relevant in evaluating market need for the project and should be addressed, as applicable, in the study of market need and feasibility submitted with the application. Because each hospital presents a unique situation, there is no formula or cutoff level that applies to all applications:

(A) Service area definition;

(B) Existing or proposed hospital;

(C) Designation as sole community provider, Critical Access Hospital, or rural referral center;

(D) Community-wide use rates (discharges and days/1000);

(E) Statewide use rates (for benchmarking purposes);

(F) Current population and 5-year projection by age cohort;

(G) Staffed versus licensed beds;

(H) Applicant hospital's occupancy rate;

(I) Competitors' occupancy rates;

(J) Outpatient volume;

(K) Availability of emergency services;

(L) Teaching hospital status;

(M) Services offered by hospitals in the service area;

(N) Migration of patients out of the service area;

(O) Planned construction at other facilities in the region;

(P) Historical market share by major service category;

(Q) Disproportionate Share Hospital designation; and

(R) Distance to other hospitals.

(2) *Operating margin and debt service coverage ratio.* (i) Hospitals with an aggregate operating margin of less than 0.00 when calculated from the three most recent annual audited financial statements are not eligible for Section 242 insurance, unless HUD determines, based on the financial data in those statements, that the hospital has achieved a financial turnaround resulting in a positive operating margin in the most recent year, calculated using classifications of items as operating or non-operating in accordance with guidance that shall be provided in written directives by HUD. In any event, HUD shall not issue an insurance commitment for any hospital in a turnaround situation that has not achieved 2 consecutive years of positive operating margin immediately prior to issuance of the commitment.

(ii) Hospitals with an average debt service coverage ratio of less than 1.25 in the 3 most recent audited years are not eligible for Section 242 insurance, unless HUD determines, based on the audited financial data, that the hospital has achieved a financial turnaround resulting in a debt service coverage ratio of at least 1.40 in the most recent year. In cases of refinancing at a lower interest rate, HUD may authorize the use of the projected debt service requirement in lieu of the historical debt in calculating the debt service coverage ratios for each of the prior 3 years. In cases where HUD authorizes the use of the projected debt service requirement in lieu of the historical debt to determine the debt service coverage ratio, hospitals must have an average debt service coverage ratio of 1.40 or greater.

(3) *Financial Feasibility.* The approval process entails a determination of the financial feasibility of the proposal, i.e., a determination that it is probable that the proposed mortgagor will be able to meet its debt service requirements during the period projected. It includes analysis of the reimbursement structure of the proposed hospital (including patient/payer mix); actions of competitors; and the probable projected impact on the proposed hospital of general health care system trends, such as the development of alternative health care delivery systems and new reimbursement methods. In addition to historical operating margin, determination of financial feasibility includes, but is not limited to, evaluation of the following factors, which the application must address and which HUD will review:

(i) Current and projected gains from operations and a manageable debt load using reasonable assumptions;

(ii) Current debt service coverage ratio of 1.25 or higher and projected debt service coverage ratio of 1.40 or higher;

(iii) Cushion in the balance sheet sufficient to demonstrate the ability to withstand short periods of net operating losses without jeopardizing financial viability;

(iv) Patient utilization forecasts (including average length of stay, case intensity, discharges, area-wide use rates) that are consistent with the hospital's historical trends, future service mix, market trends, population forecasts, and business climate;

(v) The hospital's demonstrated ability to position itself to compete in its marketplace;

(vi) Organizational affiliations or relationships that help optimize financial, clinical, and operational performance;

(vii) Management's demonstrated ability to operate effectively and efficiently, and to develop effective strategies for addressing problem areas;

(viii) Systems in place to monitor hospital operations, revenues, and costs accurately and in a timely manner;

(ix) A Board that is appropriately constituted and provides effective oversight;

(x) Required licensures and approvals; and

(xi) Favorable ratings from the Joint Commission on Accreditation of Healthcare Organizations or other organizations acceptable to HUD.

(4) *Preliminary Review.* A Preliminary Review is a general overview of the acceptability of a potential mortgagor performed at the request of a hospital, a financial consultant representing a hospital, or a lender, to identify any factors that would likely cause an application to be rejected, should an application be submitted.

(i) The purpose of the preliminary review is for HUD to identify any obvious factors that would cause an application to be rejected, before the potential mortgagor or mortgagee expends resources to prepare one. The hospital, financial consultant, or lender shall submit a preliminary information package to HUD that provides evidence of statutory eligibility, market need, financial strength, and such other documentation as HUD may require. The scope of the preliminary review does not include approval of any specific site in the community.

(ii) If HUD identifies factors that would cause an application to be rejected, HUD shall issue a Preliminary Review Letter notifying the potential applicant that an application for mortgage insurance would probably not be successful and providing the reasons for this decision. Also, no further request from the proposed applicant for a Preliminary Review shall be entertained for a period of one year from the date of HUD's notification. HUD may grant an exception to this one-year limitation if, during the year, there is a major change in the circumstances that caused HUD to determine that the project would be rejected. For example, if the sole reason for HUD's determination was the hospital's failure to meet the historical operating margin test, and a new audited annual financial statement contains results that would

cause the hospital to meet the test, then the lender may request a new Preliminary Review within one year of HUD's notification.

(iii) If HUD does not identify any factors that would cause an application to be rejected, HUD shall issue a Preliminary Review Letter advising the potential applicant that there appears to be no bar to the applicant's proceeding to the next step in the application process, provided that if a complete application is not received by HUD within one year following the date of HUD's letter, another Preliminary Review may be required, at HUD's discretion, before the application process may proceed.

(iv) The Commissioner's determination in the preliminary review phase that no factors have been identified that would cause an application to be rejected shall in no way be construed as an indication that a subsequent application will be approved.

(5) *Preapplication meeting.* The next step in the application process is the preapplication meeting. At HUD's discretion, this meeting may be held at HUD Headquarters in Washington, DC, or at another site agreeable to HUD and the potential applicant. The preapplication meeting is an opportunity for the potential mortgagor to summarize the proposed project, for HUD to summarize the application process, and for issues that could affect the eligibility or underwriting of the project to be identified and discussed to the extent possible. Following the meeting, HUD may:

(i) Advise the potential applicant that there appears to be no bar to submitting an application for mortgage insurance; or

(ii) Identify issues that must be resolved before a full application should be submitted for processing.

(b) *Application contents.* The application for mortgage insurance shall include exhibits that follow such guidance as to content and format that HUD shall provide from time to time. The application shall include:

(1) A description of the proposed sources and uses of funds;

(2) A description of the mortgagor entity, its ownership structure, and its directors and managers;

(3) A description of the project, the business plan of the hospital, and how the project will further that plan;

(4) Historical audited financial statements and interim year-to-date financial results (for existing hospitals);

(5) A study of market need and financial feasibility, addressing the factors listed in paragraphs (a)(1)(ii), (a)(2), and (a)(3) of this section, with assumptions and financial forecast clearly presented, and prepared by a certified accounting firm acceptable to HUD;

(6) Architectural plans and specifications in sufficient detail to enable a reasonable estimate of cost;

(7) Evidence that the hospital will be located in a state or political subdivision of a state with reasonable minimum standards of licensure and methods of operation for hospitals and satisfactory assurance that such standards will be applied and enforced with respect to the hospital;

(8) If the state has an official procedure for determining need for hospitals, evidence that such procedure has been followed and that need has been established under that procedure;

(9) A Phase I environmental report; and

(10) Such other exhibits as HUD shall require based upon the facts pertaining to the particular case.

(c) *Fee.* An application fee of $1.50 per thousand dollars of the amount of the loan to be insured shall be paid to HUD at the time the application is submitted to HUD for approval.

(d) *Filing of application.* An application for insurance of a mortgage on a project shall be submitted on an approved FHA form by an approved mortgagee and by the sponsors of such project to the FHA Office of Insured Health Care Facilities.

(e) *Complete application.* Only technically complete applications will be processed. Partial applications cannot be processed. Upon determination that an application is complete, HUD shall issue a Completeness Letter to the applicant stating that the application is complete.

(f) *Application Review.* Upon receipt of a complete application, HUD shall evaluate the application to determine if eligibility, market need, financial feasibility, and compliance with applicable regulations (including but not limited to federal environmental regulations, wage rate regulations, and health care regulations) have been demonstrated, and to evaluate any other factors, including but not limited to risk to the Insurance Fund, that should be considered in determining if the application for mortgage insurance should be approved. As a part of this review, HUD may solicit the advice of private consultants and expert staff in the Department of Health and Human Services and other federal agencies. Based on review of the complete application, HUD may request additional information from the applicant. The timeliness of the applicant's submission of the additional information may affect the approval or disapproval of the application. The Commissioner's decision shall be communicated in the form of a Commitment Letter or a Rejection Letter. HUD will not issue a Commitment Letter until HUD completes the environmental review under 24 CFR 242.79.

§ 242.17 Commitments.

(a) *Issuance of commitment.* Upon approval of an application for insurance, a commitment shall be issued by HUD setting forth the terms and conditions under which an insurance endorsement shall be issued for the hospital. The commitment shall include the following:

(1) A commitment for insurance of advances reflecting the mortgage amount, interest rate, mortgage term, date of commencement of amortization, and other requirements pertaining to the mortgage and construction project;

(2) HUD's computation of the replacement cost and maximum insurable mortgage amount;

(3) Financial requirements for closing;

(4) Approval covenants, including any special conditions that must be satisfied prior to initial endorsement;

(5) Mortgage Reserve Fund Agreement.

(b) *Type of commitment.* The commitment will provide for the insurance of advances of mortgage funds during construction.

(c) *Term of commitment.* (1) The initial commitment shall be issued for a period of 90 days.

(2) The term of a commitment may be extended in such manner as HUD may prescribe, provided, however, that the combined term of the original commitment and any extensions do not exceed 180 days.

(d) *Commitment fee.* A commitment fee that, when added to the application fee, will aggregate $3 per thousand dollars of the amount of the loan set forth in the commitment, shall be paid within 30 days of the date of issuance of the commitment. If such fee is not paid within this 30-day period, the commitment shall automatically terminate.

§ 242.18 Inspection fee.

The commitment may provide for the payment of an inspection fee in an amount not to exceed $5 per thousand dollars of the commitment. The inspection fee shall be paid at the time of initial endorsement.

§ 242.19 Fees on increases.

(a) *Increase in commitment prior to endorsement.* An application, filed prior

to initial endorsement, for an increase in the amount of an outstanding commitment, shall be accompanied by an additional application fee of $1.50 per thousand dollars computed on the amount of the increase requested. Any increase in the amount of a commitment shall be subject to the payment of an additional commitment fee which, when added to the additional application fee, will aggregate $3 per thousand dollars of the amount of the increase. The additional commitment fee shall be paid within 30 days after the date of the amended commitment. If the additional commitment fee is not paid within 30 days, the commitment novation providing for the increased amount will automatically terminate and the previous commitment will be reinstated. If an inspection fee was required in the original commitment, an additional inspection fee shall be paid in an amount not to exceed $5 per thousand dollars of the amount of increase in commitment. The additional inspection fee shall be paid at the time of initial endorsement.

(b) *Increase in mortgage between initial and final endorsement.* Upon an application, filed between initial and final endorsement, for an increase in the amount of the mortgage, either by amendment, consolidation agreement, or by substitution of a new mortgage, an additional application fee of $1.50 per thousand dollars computed on the amount of the increase requested shall accompany the application. The approval of any increase in the amount of the mortgage shall be subject to the payment of an additional commitment fee which, when added to the additional application fee, will aggregate $3 per thousand dollars of the amount of the increase granted. If an inspection fee was required in the original commitment, an additional inspection fee shall be paid in an amount not to exceed $5 per thousand dollars of the amount of the increase granted. The additional commitment and inspection fees shall be paid within 30 days after the date that the increase is granted.

§ 242.20 Reopening of expired commitments.

An expired commitment may be reopened if a request for reopening is received by HUD no later than 90 days after the date of expiration of the commitment. The reopening request shall be accompanied by a fee of 50 cents per thousand dollars of the amount of the expired commitment. A commitment that has expired because of failure to pay the commitment fee may be reopened only upon payment of the commitment fee and the reopening fee. If the reopening request is not received by HUD within the required 90-day period, a new application accompanied by an application fee must be submitted. If a commitment for an increased amount has expired because of failure to pay an additional commitment fee based on the amount of the increase, the reopening fee shall be computed on the basis of the amount of the commitment increase rather than on the amount of the original commitment.

§ 242.21 Refund of fees.

Commitment, inspection, and reopening fees (but not application fees) may be refunded, in whole or in part, if HUD determines that the construction or financing of the project has been prevented because of condemnation proceedings or other legal action taken by a government body or public agency, or in such other instances as HUD may determine as being beyond the control of the applicant and resulting from no fault of the applicant. A transfer fee may be refunded only in such instances as HUD may determine. However, the portion of the inspection fee paid in connection with early commencement of work is not refundable.

§ 242.22 Maximum fees and charges by mortgagee.

The mortgagee may collect from the mortgagor the amount of the fees provided for in this subpart. The mortgagee may also collect from the mortgagor an initial service charge not to exceed 2 percent of the original principal amount of the mortgage to reimburse the mortgagee for the cost of closing the transaction. A permanent financing fee not to exceed 3.5 percent may be collected from the mortgagor; however, the combined initial service charge and permanent financing fee may not exceed 5.5 percent in bond transactions and 3.5 percent in all other transactions. Any additional charges or fees collected from the mortgagor shall be subject to prior approval of HUD and shall be clearly disclosed in the Mortgagee's Certificate.

§ 242.23 Maximum mortgage amounts and cash equity requirements.

(a) *Adjusted mortgage amount—rehabilitation projects.* A mortgage financing the rehabilitation of an existing hospital shall be subject to the following limitations, in addition to those set forth in § 242.7:

(1) Property held unencumbered. If the mortgagor is the fee simple owner of the property and the ownership is not encumbered by an outstanding indebtedness, the mortgage shall not exceed 100 percent of HUD's estimate of the cost of the proposed rehabilitation.

(2) Property subject to existing mortgage. If the mortgagor owns the property subject to an outstanding indebtedness, which is to be refinanced with part of the insured mortgage, the mortgage shall not exceed the total of the following:

(i) The Commissioner's estimate of the cost of rehabilitation, plus

(ii) Such portion of the outstanding indebtedness as does not exceed 90 percent of HUD's estimate of the fair market value of such land and improvements prior to rehabilitation.

(3) Property to be acquired. If the property is to be acquired by the mortgagor and the purchase price is to be financed with a part of the insured mortgage, the mortgage shall not exceed 90 percent of the total of the following:

(i) The Commissioner's estimate of the cost of rehabilitation, plus

(ii) The actual purchase price of the land and improvements or HUD's estimate (prior to rehabilitation) of the fair market value of such land and improvements, whichever is the lesser.

(b) *Reduced mortgage amount—leaseholds.* In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value or replacement cost of the property described in the mortgage shall be the value or replacement cost of the leasehold estate (as determined by HUD), which shall in all cases be less than the value or replacement cost of the property in fee simple.

(c) *Cash equity.* Depending on the financial circumstances of each hospital facility, HUD shall have the discretion to evaluate, on a case-by-case basis, the amount of equity that a mortgagor must supply in addition to the value of plant, property, and equipment and other values recognized as loan security in the commitment process. Exercise of this discretion shall never cause a loan to exceed 90 percent of estimated replacement cost, although it may cause it to be less than 90 percent. The equity contribution may not be made from borrowed funds. A private nonprofit or public mortgagor, but not a proprietary mortgagor, in HUD's discretion and subject to 24 CFR 242.49, may provide any such required equity in the form of a letter of credit.

§ 242.24 Initial operating costs.

In the case of a new hospital or a hospital expansion, HUD shall establish, on a case-by-case basis, the amount of initial operating capital, if any, that must be deposited in cash or a letter of credit (or combination) to be available to the new hospital upon commencement

of operations. Generally, the initial operating capital other than AMPO shall not be borrowed funds unless HUD determines that there are offsetting financial strengths to compensate for the risk associated with borrowing.

Subpart C—Mortgage Requirements

§ 242.25 Mortgage form and disbursement of mortgage proceeds.

(a) *Mortgage form.* The mortgage shall be:

(1) Executed on a form approved by HUD for use in the jurisdiction in which the property covered by the mortgage is situated; the form shall not be changed without the prior written approval of HUD.

(2) Executed by an eligible mortgagor.

(b) *Disbursement of mortgage proceeds.* The mortgagee shall be obligated, as a part of the mortgage transaction, to disburse the principal amount of the mortgage to (or for the account of) the mortgagor or to his or her creditors for his or her account and with his or her consent.

§ 242.26 Agreed interest rate.

(a) The mortgage shall bear interest at the rate or rates agreed upon by the mortgagee and the mortgagor.

(b) The amount of any increase approved by HUD in the mortgage amount between initial and final endorsement in excess of the amount that HUD had committed to insure at initial endorsement shall bear interest at the rate agreed upon by the mortgagee and the mortgagor.

§ 242.27 Maturity.

The mortgage shall have a maturity not to exceed 25 years from the date amortization begins.

§ 242.28 Allowable costs for consultants.

Consulting fees for work essential to the development of the project may be included in the insured mortgage. Allowable consulting fees include those for analysis of market demand, expected revenues, and costs; site analysis; architectural and engineering design; and such other fees as HUD may determine to be essential to project development. Fees for work performed more than 2 years prior to application are not allowable. Fees for work performed by any party with an identity of interest with the proposed mortgagor or mortgagee are not allowable.

§ 242.29 Payment requirements.

The mortgage shall provide for payments on the first day of each month in accordance with an amortization plan agreed upon by the mortgagor, the mortgagee, and HUD.

§ 242.30 Application of payments.

All payments to be made by the mortgagor to the mortgagee shall be added together and the aggregate amount thereof shall be paid by the mortgagor each month in a single payment. The mortgagee shall apply each payment received to the following items in the following order:

(a) Premium charges under the contract of mortgage insurance;

(b) Ground rents, taxes, special assessments, and fire and other hazard insurance premiums;

(c) Interest on the mortgage; and

(d) Amortization of the principal of the mortgage.

§ 242.31 Accumulation of accruals.

(a) The mortgage shall provide for payments by the mortgagor to the mortgagee on each interest payment date of an amount sufficient to accumulate, in the hands of the mortgagee one payment period prior to its due date, the next annual MIP payable by the mortgagee to HUD. Such payments shall continue only so long as the contract of insurance shall remain in effect.

(b) The mortgage shall provide for such equal monthly payments by the mortgagor to the mortgagee as will amortize the ground rents, if any, and the estimated amount of all taxes, water charges, special assessments, and fire and other hazard insurance premiums, within a period ending one month prior to the dates on which the same become delinquent. The mortgage shall further provide that such payments shall be held by the mortgagee, for the purpose of paying such items before they become delinquent. The mortgage shall also make provision for adjustments in case such estimated amounts shall prove to be more, or less, than the actual amounts so paid therefore by the mortgagor. Notwithstanding the foregoing, in particular circumstances, a mortgagor may purchase required fire and hazard insurance through a consortium of affiliated institutions or related organizations or, in the case of public institutions, through required state purchasing arrangements. In such circumstances, the mortgage accrual requirement may be modified to reflect circumstances in which it is inappropriate for the mortgagee to collect monthly payments and to make payments on behalf of the mortgagor.

§ 242.32 Covenant against liens.

The mortgage shall contain a covenant against the creation by the mortgagor of any liens against the property, except for such liens as may be approved by HUD.

§ 242.33 Covenant for malpractice, fire, and other hazard insurance.

The mortgage shall contain a covenant binding the mortgagor to maintain adequate liability, fire, and extended coverage insurance on the property. The mortgage shall also contain a covenant binding the mortgagor to maintain adequate malpractice coverage. All coverage shall be acceptable to the mortgagee and HUD.

§ 242.35 Mortgage lien certifications.

At initial and/or final endorsement of the mortgage note, each of the following requirements must be met:

(a) The mortgage is the first lien upon and covers all of the property used in the operation of the entire hospital;

(b) The property upon which the improvements have been made or constructed and the equipment financed with mortgage proceeds are free and clear of all liens other than the insured mortgage and such other secondary liens as may be approved by HUD;

(c) The Security Agreement and Uniform Commercial Code filings establish a first lien on the personalty of the mortgagor, including but not limited to equipment acquired with mortgage proceeds or otherwise not subject to a prior lien;

(d) The mortgagor has notified HUD in writing of all unpaid obligations in connection with the mortgage transaction, the purchase of the mortgaged property, the construction or rehabilitation of the project, or the purchase of the equipment financed with mortgage proceeds.

§ 242.37 Mortgage prepayment.

(a) *Prepayment privilege.* Except as provided in paragraph (c) of this section or otherwise established by HUD, the mortgage shall contain a provision permitting the mortgagor to prepay the mortgage in whole or in part upon any interest payment date, after giving the mortgagee a 30-day notice in writing in advance of its intention to so prepay. The 30-day notice may be extended with the prior written approval of HUD.

(b) *Prepayment charge.* The mortgage may contain a provision for such charge, in the event of prepayment of principal, as may be agreed upon between the mortgagor and the mortgagee, subject to the following:

(1) The mortgagor shall be permitted to prepay up to 15 percent of the original principal amount of the mortgage in any one calendar year without any such charge.

(2) Any reduction in the original principal amount of the mortgage resulting from the certification of cost, which HUD may require, shall not be

construed as a prepayment of the mortgage.

(c) *Prepayment of bond-financed or GNMA-securitized mortgages.* Where the mortgage is given to secure GNMA mortgage-backed securities or a loan made by a lender that has obtained the funds for the loan by the issuance and sale of bonds or bond anticipation notes, or both, the mortgage may contain a prepayment restriction and prepayment penalty charge acceptable to HUD as to term, amount, and conditions.

(d) *HUD override of prepayment restrictions.* In the event of a default, HUD may override any lockout, prepayment penalty, or combination of penalties in order to facilitate a partial or full refinancing of the mortgaged property and avoid a claim.

§ 242.38 Late charge.

The mortgage may provide for the collection by the mortgagee of a late charge in accordance with terms, conditions, and standards of HUD for each dollar of each payment to interest or principal more than 15 days in arrears, to cover the expense involved in handling delinquent payments. Late charges shall be separately charged to and collected from the mortgagor and shall not be deducted from any aggregate monthly payment.

Subpart D—Endorsement for Insurance

§ 242.39 Insurance endorsement.

Initial endorsement of the mortgage note shall occur before any mortgage proceeds are insured, and the time of final endorsement shall be as set forth in paragraph (b) of this section.

(a) *Initial endorsement.* The Commissioner shall indicate the insurance of the mortgage by endorsing the original mortgage note and identifying the section of the Act and the regulations under which the mortgage is insured and the date of insurance.

(b) *Final endorsement.* When all advances of mortgage proceeds have been made and all the terms and conditions of the commitment have been met to HUD's satisfaction, HUD shall indicate on the original mortgage note the total of all advances approved for insurance and again endorse such instrument.

(c) *Contract rights and obligations.* The Commissioner and the mortgagee or lender shall be bound from the date of initial endorsement by the provisions of the Contract of Mortgage Insurance stated in subpart B of part 207, which is hereby incorporated by reference into this part.

§ 242.40 Mortgagee certificate.

At initial endorsement, the mortgagee shall execute a Mortgagee Certificate in a form prescribed by HUD.

§ 242.41 Certification of cost requirements.

Before initial endorsement of the mortgage for insurance, the mortgagor, the mortgagee, and HUD shall enter into an agreement in form and content satisfactory to HUD for the purpose of precluding any excess of mortgage proceeds over statutory limitations. Under this agreement, the mortgagor shall disclose its relationship with the builder, including any collateral agreement, and shall agree:

(a) To execute a Certificate of Actual Costs, upon completion of all physical improvements on the mortgaged property.

(b) To apply any cost savings in accordance with the provisions below.

§ 242.42 Certificates of actual cost.

(a) The mortgagor's certificate of actual cost, in a form prescribed by HUD, shall be submitted upon completion of the physical improvements to the satisfaction of HUD and before final endorsement, except that in the case of an existing hospital that does not require substantial rehabilitation and where the commitment provides for completion of specified repairs after endorsement, a supplemental certificate of actual cost will be submitted covering the completed costs of any such repairs. The certificate shall show the actual cost to the mortgagor, after deduction of any kickbacks, rebates, trade discounts, or other similar payments to the mortgagor, any of its officers, directors, stockholders, partners, or other entity member ownership, of construction and other costs, as prescribed by HUD.

(b) The Certificate of Actual Cost shall be verified by an independent certified public accountant or independent public accountant in a manner acceptable to HUD.

(c) Upon HUD's approval of the mortgagor's certification of actual cost, such certification shall be final and incontestable except for fraud or material misrepresentation on the part of the mortgagor.

§ 242.43 Application of cost savings.

At the sole discretion of HUD, any cost savings shall be used to:

(a) Reduce the principal amount of the mortgage and the mortgagor's cash equity contribution proportionally, unless the mortgagor elects to have a greater portion of the savings used to reduce the mortgage; and/or

(b) Fund any additional construction or substantial rehabilitation approved by HUD.

Subpart E—Construction

§ 242.44 Construction standards.

Work designed and performed under this section shall conform to the standards adopted by HUD, which, at a minimum, shall include the ''Guidelines for Construction and Equipment of Hospital and Medical Facilities,'' which is regularly updated and published by the American Institute of Architects.

§ 242.45 Early commencement of work.

(a) *Site preparation.* Prior to or following the submission of an application, the mortgagor may request for good cause the commencement of certain limited site preparation for the project within legal guidelines and state law. Such work can commence only after the review of the work and concurrence by HUD, including the environmental review under 24 CFR 242.79, previous participation review, and the agreement to certain conditions by the applicant. HUD will not approve such request until it has completed the environmental review under 24 CFR 242.79. The work must meet all requirements and guidelines as if it were approved for mortgage insurance and is to be accomplished at the sole risk of the mortgagor.

(b) *Construction completed prior to application.* Structures completed more than 2 years prior to application are eligible to be refinanced with insured mortgage proceeds.

(c) *Pre-commitment work.* Subsequent to submission of an application but prior to the issuance of a commitment or denial by HUD, the hospital and lender may request for good cause the commencement of certain necessary early site work and limited construction activity in connection with the improvements, within legal guidelines and state law. This work must be requested by both the hospital and the lender to be approved. Such work may be eligible to be financed with insured mortgage proceeds if the application is approved and the work complies with all specified conditions of HUD as set forth in a written agreement between the hospital and HUD. It is understood that in some cases the application submitted in order for pre-commitment work to begin may not be complete in all respects. However, at a minimum, the application shall include the approved FHA application form, the application fee (based on the amount of the total proposed insured loan), the inspection fee (based on the cost of the pre-

commitment work), a project description of the pre-commitment work and its relation to the total project, and plans and specifications for the proposed pre-commitment work in sufficient detail to allow HUD to conduct its architectural and engineering review and obtain the necessary previous participation information and evidence of compliance with federal and state environmental regulations. Such work can commence only after the review of the work and concurrence by the lender and HUD, including previous participation review. HUD will not approve such request until it has completed the environmental review under 24 CFR 242.79. The work must meet all requirements and guidelines as if it were approved for mortgage insurance and is to be accomplished at the sole risk of the hospital. A request shall be accompanied by documentation required by HUD. That documentation shall include:

(1) A justification explaining the urgent and compelling circumstances that make it necessary to begin construction without waiting for the application process to run its course. The justification must specify the harm the hospital would suffer from waiting.

(2) A plan detailing how the hospital will finance the limited construction if the application for mortgage insurance is denied.

(3) A statement that financing the limited construction by means other than a HUD-insured mortgage in the event the application is denied will impose no significant financial hardship on the hospital. The statement shall be accompanied by supporting historical and projected financial data.

(4) A statement that the hospital recognizes that HUD's agreement to include the cost of the limited construction in a subsequently approved application does not in any way indicate that the application will be approved.

(5) A resolution of the governing body (or, at HUD's discretion, the executive committee of the governing body) of the mortgagor attesting to paragraphs (c)(1) through (4).

(d) *Early Start.* Subsequent to the issuance of a commitment, if the hospital and lender request the commencement of the project, the work may commence after the review and approval of the request by HUD, including the agreement by the hospital and the lender to any conditions that HUD may require. Any work undertaken prior to the initial endorsement shall be at the sole risk of the hospital.

(e) *Prepayment of inspection fee.* The hospital shall pay a non-refundable inspection fee to HUD before the work described in paragraph (c) or (d) of this section commences. The fee shall be based on the amount of the pre-commitment and/or early start work requested to be included in the insured mortgage loan.

(f) *No expressed or implied intent.* Approval to proceed under paragraphs (c) or (d) of this section shall in no way be construed as indicating any intent, expressed or implied, on the part of HUD to approve, disapprove, or make any undertaking or promise whatsoever with respect to the application or with respect to any commitment for mortgage insurance. Any work under paragraphs (c) or (d) of this section shall be undertaken at the sole risk and responsibility of the hospital.

§ 242.46 Insured advances—building loan agreement.

Prior to the initial endorsement of the mortgage for insurance, the mortgagor and mortgagee shall execute a building loan agreement, approved by HUD, setting forth the terms and conditions under which progress payments may be advanced during construction. To be covered by mortgage insurance, or to be included as an eligible cost, each progress payment involving mortgage proceeds and the owner's equity requirement shall be approved by HUD.

§ 242.47 Insured advances for building components stored off-site.

(a) Building components. In insured advances for building components stored off-site, the term building component shall mean any manufactured or pre-assembled part of a structure that HUD has specifically identified for incorporation into the property and has designated for off-site storage because it is of such size or weight that:

(1) Storage of the number of components required for timely construction progress at the construction site is impractical, or

(2) Weather damage or other adverse conditions prevailing at the construction site would make storage at the site impractical or unduly costly.

(b) *Storage.* (1) An insured advance may be made for up to 90 percent of the invoice value (to exclude costs of transportation and storage) of the building components stored off-site, if the components are stored at a location approved by the mortgagee and HUD.

(2) Each building component shall be adequately marked so as to be readily identifiable in the inventory of the off-site location. Each component shall be kept together with all other building components of the same manufacturer intended for use in the same project for which insured advances have been made and separate and apart from similar units not for use in the project.

(3) Storage costs, if any, shall be borne by the contractor.

(c) *Responsibility for transportation, storage, and insurance of off-site building components.* The general contractor of the insured mortgaged property shall have the responsibility for:

(1) Insuring the components in the name of the mortgagor while in transit and storage; and

(2) Delivering or contracting for the delivery of the components to the storage area and to the construction site, including payment of freight.

(d) *Advances.* (1) Before an advance for a building component stored off-site is insured: (i) The mortgagor shall:

(A) Obtain a bill of sale for the component;

(B) Give the mortgagee a security agreement; and

(C) File a financing statement in accordance with the Uniform Commercial Code; and

(ii) The mortgagee shall warrant to HUD that the security instruments are a first lien on the building components covered by the instruments except for such other liens or encumbrances as may be approved by HUD.

(2) Before each advance for building components stored off-site is insured, the mortgagor's architect shall certify to HUD that the components, in their intended use, comply with HUD-approved contract plans and specifications. Under those circumstances permitted by HUD in which there is no architect, compliance with the HUD-approved contract plans and specifications shall be determined by HUD.

(3) Advances may be made only for components stored off-site in a quantity required to permit uninterrupted installation at the site.

(4) At no time shall the invoice value of building components being stored off-site, for which advances have been HUD insured, represent more than 50 percent of the total estimated construction costs for the insured mortgaged project as specified in the construction contract. Notwithstanding the preceding sentence and other regulatory requirements that set bonding requirements, the percentage of total estimated construction costs insured by advances under this section may exceed 25 percent but not 50 percent if the mortgagor furnishes assurance of completion in the form of a corporate

surety bond for the payment and performance each in the amount of 100 percent of the amount of the construction contract. In no event will insurance of advances for components stored off-site be made in the absence of a payment and a performance bond.

(5) No single advance that is to be insured shall be in an amount less than $10,000.

§ 242.48 Insured advances for certain equipment and long lead items.

The Commissioner may allow advances for certain pieces of equipment or other construction materials for which a manufacturer, fabricator, or other source requires an interim payment(s) in order to assure the timely manufacture or fabrication and delivery to the project site. Such advances can be made only if a bill of sale or an invoice describes the material or equipment and its completion and delivery dates in no uncertain terms, and that such displayed timetable is necessary to meet the requirements of the overall construction schedule cited in the construction contract.

§ 242.49 Funds and finances: deposits and letters of credit.

(a) *Deposits.* Where HUD requires the mortgagor to make a deposit of cash or securities, such deposit shall be with the mortgagee or a depository acceptable to the mortgagee. Any such deposit shall be held in a separate account for and on behalf of the mortgagor, and shall be the responsibility of the mortgagee.

(b) *Letter of credit.* Where the use of a letter of credit is acceptable to HUD in lieu of a deposit of cash or securities, the letter of credit shall be issued to the mortgagee by a banking institution acceptable to the lender. The mortgagee shall be responsible to HUD for collection under the letter of credit. In the event a demand for payment thereunder is not immediately met, the mortgagee shall forthwith provide a cash deposit equivalent to the undrawn balance of the letter of credit.

(c) *Mortgagee not issuer.* The mortgagee of record may not be the issuer of the letter of credit without the prior written consent of HUD.

§ 242.50 Funds and finances: off-site utilities and streets.

The Commissioner shall require assurance of completion of off-site public utilities and streets in all cases, except where a municipality or other public body has by agreement acceptable to HUD agreed to install such utilities and streets without cost to the mortgagor. Where such assurance is required, it shall be either in the form of a cash escrow deposit or the retention of a specified amount of mortgage proceeds by the mortgagee, or both. In any case, the amount of deposit or retained cash (or both) must be sufficient to cover the cost of off-site utilities and streets. If a cash escrow is used, it shall be deposited with the mortgagee or with an acceptable trustee or escrow agent designated by the mortgagee. If mortgage proceeds are used, the mortgagee shall retain under terms approved by HUD, rather than disburse at the initial closing of the mortgage, a sufficient portion of the mortgage proceeds allocated to land in the project analysis. As additional assurance, HUD may also require a surety company bond or bonds.

§ 242.51 Funds and finances: Insured advances and assurance of completion.

(a) Where the estimated cost of construction or substantial rehabilitation is more than $500,000, the mortgagor shall furnish assurance of completion in the form of corporate surety bonds for payment and performance, each in the minimum amount of 100 percent of the construction contract (or Guaranteed Maximum Price, in the case of construction management) and each satisfactory to HUD.

(b) All types of assurance of completion shall be on forms approved by HUD. All surety companies executing a bond and all parties executing a personal indemnity agreement must be satisfactory to HUD.

(c) A mortgagee may prescribe more stringent requirements for assurance of completion than the minimum requirements provided for in this section.

§ 242.52 Construction contracts.

(a) *Awarding of contract.* A contract for the construction or rehabilitation of a hospital shall be entered into by a mortgagor, with a builder selected by a competitive bidding procedure acceptable to HUD.

(b) *Form of contract.* The construction contract shall be: A lump sum form providing for payment of a specified amount; a construction management contract with a guaranteed maximum price, the final costs of which are subject to a certification acceptable to HUD; a design-build contract with terms and certification requirements acceptable to HUD; or such other form of contract as may be acceptable to HUD.

(c) *Competitive bidding.* A competitive bidding procedure acceptable to HUD must be used in the selection of bidders to perform work or otherwise provide service to the project, the costs of which are included in any form of construction contract cited in paragraph (b) of this section. Fixed equipment not included in the construction contract, and movable equipment, may be purchased by securing quotations or by using competitive bidding procedures.

§ 242.53 Excluded contractors.

(a) Contracts relating to the construction of the project shall not be made with any person or entity that has been excluded from participation in federal programs, including but not limited to: A general contractor, a subcontractor, or construction manager (or any firm, corporation, partnership, or association in which such contractor, subcontractor, or construction manager has a substantial interest). Before entering into contracts with any such person or entity, owners must consult the government-wide list of excluded parties, and any list of excluded parties maintained by HUD.

(b) Contracts relating to the construction of the project shall not be made with a general contractor that has an identity of interest, as defined by HUD, with the mortgagor or mortgagee.

(c) If HUD determines that a contract has been made contrary to the requirements of paragraphs (a) or (b) of this section and so notifies the mortgagee, HUD will require the contractor or construction manager to cost-certify and may require other remedial action in addition to taking enforcement action, as HUD deems appropriate.

Subpart F—Nondiscrimination and Wage Rates

§ 242.54 Nondiscrimination.

Hospital facilities financed with mortgages insured under this part must be made available without discrimination as to race, color, religion, sex, age, disability, or national origin. Hospitals must be operated in compliance with all applicable civil rights laws and regulations, including 24 CFR part 200, subpart J (Equal Employment Opportunity), and the Americans with Disabilities Act (42 U.S.C. 12101 *et seq.*). Racially restrictive covenants are per se illegal and their use is prohibited. The aforesaid provisions regarding age and sex discrimination do not affect the eligibility of hospitals for women and children.

§ 242.55 Labor standards.

(a) Projects financed under this part (except under 24 CFR 242.91) must comply with the prevailing wage rates determined under the Davis-Bacon Act

(40 U.S.C. 3141 *et seq.*), and U.S. Department of Labor regulations in 29 CFR parts 1, 3, and 5 for compliance with labor standards laws, in accordance with section 212 of the Act, provided that supplemental loans under section 241 of the Act made in connection with loans insured under this part are subject to labor standards requirements in the same manner and to the same extent as mortgages insured under section 242 of the National Housing Act.

(b) The requirements stated in 24 CFR part 70 governing HUD waiver of Davis-Bacon prevailing wage rates for volunteers apply to hospitals with mortgages insured under this part.

(c) Each laborer or mechanic employed on any facility covered by a mortgage insured under this part (except under 24 CFR 242.91, but including a supplemental loan under section 241 of the National Housing Act made in connection with a loan insured under this part) shall receive compensation at a rate not less than 1.5 times the basic rate of pay for all hours worked in any workweek in excess of 8 hours in any workday or 40 hours in the workweek.

(d) Project commitments, contracts, and agreements, as determined by HUD, and construction contracts and subcontracts, shall include terms, conditions, and standards for compliance with applicable requirements set forth in 29 CFR parts 1, 3, and 5 and section 212 of the Act.

(e) No advance under a loan or mortgage that is subject to the requirements of section 212 shall be eligible for insurance unless there is filed with the application for the advance a certificate as required by HUD certifying that the laborers and mechanics employed in construction of the project have been paid not less than the wage rates required under section 212.

Subpart G—Regulatory Agreement, Accounting and Reporting, and Financial Requirements

§ 242.56 Form of regulation.

As long as HUD is the insurer or holder of the mortgage, all mortgagors shall be regulated by HUD through the use of a regulatory agreement in a published format determined by HUD and such additional covenants and restrictions as may be determined necessary by HUD on a case-by-case basis. In addition, all mortgagors shall be subject to the provisions of 24 CFR part 24 and such other enforcement provisions as may be applicable. The mortgagor shall be subject to monitoring by HUD and its agents and contractors, on an ongoing basis for the life of the insured mortgage to ensure against the risk of default, and the mortgagor must make its financial records available to HUD and its agents and contractors upon request.

§ 242.57 Maintenance of hospital facility.

The mortgagor shall maintain the hospital's grounds, buildings, and the equipment financed with mortgage proceeds in good repair, and shall promptly complete such repairs and maintenance as HUD considers necessary.

§ 242.58 Books, accounts, and financial statements.

(a) *Books and accounts.* The mortgagor's books and accounts relating to the operation of the physical facilities of the hospital shall be established in a manner satisfactory to HUD, and shall be kept in accordance with the requirements of HUD as long as the mortgage is insured or held by HUD.

(b) *Financial reports.* The mortgagor shall file with HUD:

(i) Annual audited financial statements in accordance with the guidance below;

(ii) Quarterly unaudited financial reports, within 40 days following the end of each quarter of the mortgagor's fiscal year;

(iii) If requested by HUD, monthly financial reports within 40 days following the end of each month;

(iv) Board-certified annual financial results within 120 days following the close of the fiscal year (if the annual audited financial statement has not yet been filed with HUD) and at such other times as HUD may designate on a case-by-case basis; and

(v) Such other financial and utilization reports as HUD may require.

(c) *Audits.* (1) Not-for-profit organizations shall conduct audits in accordance with the Consolidated Audit Guide for Audits of HUD Programs (Handbook 2000.04) and OMB Circular A–133 (Audits of states, local governments, and nonprofit organizations).

(2) For-profit organizations shall conduct audits in accordance with the Consolidated Audit Guide for Audits of HUD Programs (Handbook 2000.04).

(d) *Changes in accounting policies.* The annual audited financial statements shall identify any changes in accounting policies and their financial effect on the balance sheet and on the income statement.

(e) *Compliance reporting.* The mortgagor shall instruct the auditor of the annual financial statement to include in its report an evaluation of the mortgagor's compliance with the Regulatory Agreement.

(f) *Books of management agents.* The books and records of management agents, lessees, operators, managers, and affiliates, as they pertain to the operations of the hospital, shall be maintained in accordance with Generally Accepted Accounting Principles (GAAP) or Governmental Accounting Standards and shall be open and available to inspection by HUD, after reasonable prior notice, during normal office hours, at the hospital or other mutually agreeable location. Every contract executed on behalf of the hospital with any of the aforesaid parties shall include the provision that the books and records of such entities shall be properly maintained and open to inspection during normal business hours by HUD at the hospital or other mutually agreeable location.

(g) *Medicare cost reports.* Upon request, the mortgagor shall provide to HUD a copy of the Medicare Cost Report most recently submitted to the Centers for Medicare and Medicaid Services (an agency of the Department of Health and Human Services), along with related financial documents.

§ 242.59 Inspection of facilities by Commissioner.

The mortgaged property (including buildings and equipment) and the books, records, and documents relating to the operation of the physical facilities of the hospital shall be subject to inspection and examination by HUD or its authorized representative at all reasonable times.

§ 242.61 Management.

The mortgagor shall provide for management of the hospital in a manner satisfactory to HUD.

(a) *Contract Management.* The mortgagor shall not execute a management agreement or any other contract for management of the hospital without HUD's prior written approval. Any management agreement or contract shall contain a provision that it shall be subject to termination without penalty and with or without cause, upon written request by HUD addressed to the mortgagor and management agent.

(b) *Principals.* HUD shall have the authority to require that any principals of the mortgagor, including but not limited to board members of a corporate entity, be removed, substituted, or terminated for cause upon written request by HUD addressed to the mortgagor.

(c) *Employees.* HUD shall have the authority to require that any key management employees of the

mortgagor (as defined and determined solely by HUD) be terminated for cause upon written request by HUD addressed to the mortgagor.

(d) *Procedures upon receipt of request under paragraphs (a) through (c) of this section.* Upon receipt of such requests under paragraphs (a) through (c) of this section, the mortgagor shall immediately terminate said management agreement, principals, or employees within the shortest applicable period HUD determines appropriate and shall make arrangements satisfactory to HUD for ongoing proper management of the hospital.

§ 242.62 Releases of lien.

The mortgagor shall not sell, dispose of, transfer, or permit to be encumbered any security property without the prior approval of the lender and Commissioner, subject to thresholds or such other standards as HUD may establish for the approval requirement. Where there is a partial release of lien, the lender must make a determination, subject to prior review and approval by HUD, that the remaining or replacement property subject to the first lien provides adequate security for the remaining principal indebtedness.

§ 242.63 Additional indebtedness and leasing.

The mortgagor shall not enter into any long-term debt, short-term debt (including receivables or line of credit financing), equipment leases, or derivative-type transactions, except in conformance with policies and procedures established by HUD.

§ 242.64 Current and future property.

All current or future property (including personalty) of the mortgagor on or off mortgaged real estate (except that specifically restricted by donors or specifically excluded by HUD) will be considered as part of the HUD-insured hospital and subject to all provisions of the HUD regulatory agreement. All equipment acquired by the hospital following initial endorsement and at any time during the term of the loan shall become subject to the lien of the security agreement and any Uniform Commercial Code Financing Statements filed pursuant to the security agreement, unless the mortgagor specifically requests and HUD, for good cause, approves subordination of the lien of the insured mortgagee on specific personalty for specific periods of time. The first lien on the realty (as defined in the regulatory agreement and as identified in the security instrument) cannot be subordinated in whole or in part.

§ 242.65 Distribution of assets.

The Commissioner shall establish financial thresholds and procedures for the distribution of surplus cash and other assets. Surplus cash that meets the definition in 24 CFR 242.1, or cash that has been expressly approved for distribution by HUD, may be distributed to other organizations formally affiliated with the mortgagor, a parent organization with which the mortgagor is also affiliated, partners, or stockholders, in accordance with those financial thresholds and procedures set forth in the regulatory agreement. Other assets may be distributed to other organizations formally affiliated with the mortgagor, a parent organization with which the mortgagor is also affiliated, partners, or stockholders, in accordance with those financial thresholds and procedures set forth in the regulatory agreement, and in accordance with the release of lien conditions in 24 CFR 242.62, if applicable.

§ 242.66 Affiliate transactions.

Transactions with affiliates that are arms-length are permitted as specified in the Regulatory Agreement. Transactions with affiliates that are not arms-length are not permitted except with the prior written approval of HUD.

§ 242.67 New corporations, subsidiaries, affiliations, and mergers.

The mortgagor shall not establish, develop, organize, acquire, become the sole member of, or acquire an interest sufficient to require disclosure on the audited financial statements of the mortgagor, in any corporation, subsidiary, or affiliate organization other than those with which the mortgagor was affiliated as of date of application, without the prior approval of HUD. The mortgagor shall obtain HUD's written approval for all future mergers.

Subpart H—Miscellaneous Requirements

§ 242.68 Disclosure and verification of Social Security and Employer Identification Numbers.

The requirements set forth in 24 CFR part 5, regarding the disclosure and verification of Social Security Numbers and Employer Identification Numbers, and Employer Identification Numbers by ''applicants for and participants in'' assisted mortgage and loan insurance and related programs, apply to this program.

§ 242.69 Transfer fee.

Upon application for review of a transfer of physical assets or the substitution of mortgagors, a transfer fee of 50 cents per thousand dollars of the outstanding principal balance of the mortgage shall be paid to HUD. A transfer fee is not required if both parties to the transfer transaction are not-for-profit or public organizations.

§ 242.70 Fees not required.

The payment of an application, commitment, inspection, or reopening fee shall not be required in connection with the insurance of a mortgage involving the sale by the Secretary of any property acquired under any section or title of the Act.

§ 242.72 Leasing of hospital.

Leasing of a hospital in its entirety is prohibited. Notwithstanding this prohibition, any proposal in which leasing of the entire facility is a factor due to state law prohibitions against the mortgaging of health care facilities by state entities shall be considered on a case-by-case basis. Also, leasing of a hospital that has an existing Section 242-insured loan is permitted if HUD determines that leasing is necessary to reduce the risk of default by a financially troubled hospital.

§ 242.73 Waiver of eligibility requirements for mortgage insurance.

The Secretary may insure under this part, without regard to any limitation upon eligibility contained in this subpart, any mortgage assigned to him or her in connection with payment under a contract of mortgage insurance, or executed in connection with a sale by him or her of any property previously insured under this part and acquired subsequent to a claim.

§ 242.74 Smoke detectors.

Each occupied room must include such smoke detectors as are required by law.

§ 242.75 Title requirements.

In order for the mortgaged property to be eligible for insurance, HUD shall determine that marketable title thereto is vested in the mortgagor as of the date the mortgage is filed for record. The title evidence shall be examined by HUD and the endorsement of the mortgage note for insurance shall be evidence of its acceptability.

§ 242.76 Title evidence.

Upon insurance of the mortgage, the mortgagee shall furnish to HUD a survey of the mortgage property, satisfactory to HUD, and a policy of title insurance covering the property, as provided in

paragraph (a) of this section. If, for reasons HUD considers to be satisfactory, title insurance cannot be furnished, the mortgagee shall furnish such evidence of title in accordance with paragraph (b) or (c) of this section as HUD may require. Any survey, policy of title insurance, or evidence of title required under this section shall be furnished without expense to HUD. The types of title evidence are:

(a) A policy of title insurance issued by a company and in a form satisfactory to HUD. The policy shall name as the insureds the mortgagee and the Secretary of Housing and Urban Development, and their successors and assigns, as their respective interests may appear. The policy shall provide that upon acquisition of title by the mortgagee or the Secretary, it will continue to provide the same coverage as the original policy, and will run to the mortgagee or the Secretary, as the case may be.

(b) An abstract of title satisfactory to HUD, prepared by an abstract company or individual engaged in the business of preparing abstracts of title, accompanied by a legal opinion satisfactory to HUD as to the quality of such title, signed by an attorney-at-law experienced in the examination of titles.

(c) A Torrens or similar title certificate.

§ 242.77 Liens.

The hospital must be free and clear of all liens other than the insured mortgage, except that the property may be subject to a lien as provided by terms and conditions established by HUD, as follows:

(a) An inferior lien made or held by a federal, state, or local government instrumentality;

(b) An inferior lien required in connection with a supplemental loan insured pursuant to section 241 of the Act;

(c) An inferior or superior lien on equipment as may be approved in connection with an equipment leasing program approved by HUD;

(d) An inferior or superior lien on accounts receivable as approved by HUD as collateral for a line of credit or other borrowing by a hospital insured under this part that has extraordinary needs such as cash flow difficulties; or

(e) Similar liens otherwise approved by HUD.

§ 242.78 Zoning, deed, and building restrictions.

The project when completed shall not violate any material zoning or deed restrictions applicable to the project site, and shall comply with all applicable building and other governmental codes, ordinances, regulations, and requirements.

§ 242.79 Environmental quality determinations and standards.

Requirements set forth in 24 CFR part 50, ''Protection and Enhancement of Environmental Quality,'' 24 CFR part 51, ''Environmental Criteria and Standards,'' and 24 CFR part 55, ''Floodplain Management,'' governing environmental review responsibilities (as applicable) and any additional environmental standards, reviews, or determinations required by HUD apply to this program.

§ 242.81 Lead-based paint poisoning prevention.

Requirements set forth in 24 CFR part 35 apply to this program.

§ 242.82 Energy conservation.

Construction, mechanical equipment, and energy and metering selections shall provide cost-effective energy conservation in accordance with standards established by HUD.

§ 242.83 Debarment and suspension.

The requirements set forth in 24 CFR part 24 apply to this program.

§ 242.84 Previous participation and compliance requirements.

The requirements set forth in 24 CFR part 200, subpart H, apply to this program.

§ 242.86 Property and mortgage assessment.

The requirements set forth in 24 CFR part 200, subpart E, regarding the mortgagor's responsibility for making those investigations, analysis, and inspections it deems necessary for protecting its interests in the property apply to these programs.

§ 242.87 Certifications.

Any agreement, undertaking, statement, or certification required by HUD shall specifically state that it has been made, presented, and delivered for the purpose of influencing an official action of the FHA, and of HUD, and may be relied upon by HUD as a true statement of the facts contained therein.

§ 242.89 Supplemental loans.

A loan, advance of credit, or purchase of an obligation representing a loan or advance of credit made for the purpose of financing improvements or additions (including the refinancing of any indebtedness incurred in connection with the early commencement of work on such improvements or additions, subject to the requirements of §§ 242.15 and 242.45) to a hospital covered by a mortgage insured under this section of the Act or for a Commissioner-held mortgage, or equipment for a hospital, may be insured pursuant to the provisions of section 241 of the Act and under the provisions of this part as applicable and such additional terms and conditions as established by HUD. See subpart B of 24 CFR part 241 with respect to the contract of mortgage insurance for all loans insured under section 241 of the Act. See 24 CFR part 241, subpart C, for energy improvements.

§ 242.90 Eligibility of mortgages covering hospitals in certain neighborhoods.

(a) A mortgage financing the repair, rehabilitation, or construction of a hospital located in an older declining urban area shall be eligible for insurance under this subpart, subject to compliance with the additional requirements of this section.

(b) The mortgage shall meet all of the requirements of this subpart, except such requirements (other than those relating to labor standards and prevailing wages or environmental review) as are judged to be not applicable on the basis of the following determinations to be made by HUD.

(1) That the conditions of the area in which the property is located prevent the application of certain eligibility requirements of this subpart.

(2) That the area is reasonably viable, and there is a need in the area for an adequate hospital to serve low and moderate income families.

(3) That the mortgage to be insured is an acceptable risk.

(c) Mortgages complying with the requirements of this section shall be insured under this subpart pursuant to section 223(e) of the National Housing Act. Such mortgages shall be insured under and be the obligation of the Special Risk Insurance Fund.

§ 242.91 Eligibility of refinancing transactions.

A mortgage given to refinance an existing insured mortgage under section 241 or Section 242 of the Act covering a hospital may be insured under this subpart pursuant to section 223(a)(7) of the Act. Insurance of the new, refinancing mortgage shall be subject to the following limitations:

(a) *Principal amount.* The principal amount of the refinancing mortgage shall not exceed the lesser of:

(1) The original principal amount of the existing insured mortgage, or

(2) The unpaid principal amount of the existing insured mortgage, to which may be added loan closing charges associated with the refinancing

mortgage, and costs, as determined by HUD, of improvements, upgrading, or additions required to be made to the property.

(b) *Debt service rate.* The monthly debt service payment for the refinancing mortgage may not exceed the debt service payment charged for the existing mortgage.

(c) *Mortgage term.* The term of the new mortgage shall not exceed the unexpired term of the existing mortgage, except that the new mortgage may have a term of not more than 12 years in excess of the unexpired term of the existing mortgage in any case in which HUD determines that the insurance of the mortgage for an additional term will inure to the benefit of the FHA Insurance Fund, taking into consideration the outstanding insurance liability under the existing insured mortgage, and the remaining economic life of the property.

(d) *Minimum loan amount.* The mortgagee may not require a minimum principal amount to be outstanding on the loan secured by the existing mortgage.

§ 242.92 Minimum principal loan amount.

A mortgagee may not require, as a condition of providing a loan secured by a mortgage insured under this part, that the principal amount of the mortgage exceed a minimum amount established by the mortgagee.

§ 242.93 Amendment of regulations.

The regulations in this subpart may be amended by HUD at any time and from time to time, in whole or in part, but such amendment shall not adversely affect the interests of a mortgagee or lender under the insurance on any mortgage or loan already insured, and shall not adversely affect the interests of a mortgagee or lender on any mortgage or loan to be insured on which HUD has issued a commitment to insure.

Dated: October 24, 2007.

Brian D. Montgomery,

Assistant Secretary for Housing—Federal Housing Commissioner.

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