

How the Federal Government is Helping Build Community Hospitals

Using HUD 242 (FHA Section 242) mortgage insurance for your next project

By David J. Brown, NCARB, AIA, and Alan Richman

Ask anyone who has been involved with the HUD 242 (FHA Section 242) Hospital Insurance Program about his or her experience, and you are likely to hear about the patience and persistence it takes to successfully participate. But, while the program is indeed complex and challenging, the rewards can be great. Particularly in today's economy, many hospitals may find that FHA-insured financing is the only way they can obtain viable and affordable funding for a new building project. A thorough understanding of the process and potential pitfalls can make all the difference.

Engaging an architect with experience in HUD 242-funded projects and a mortgage banker specializing in the HUD 242 program is essential, as integration of financing and design tasks into a project design schedule is key to success. This design schedule ties all the critical dates and deadlines together, ensuring that in the cumulative process no piece is left out.

The design schedule for a HUD 242 project will be slightly longer than a conventionally financed project schedule, as it incorporates HUD's Division of Architecture and Engineering (DAE) in the process. DAE's role is to protect HUD's interests by reviewing, approving, and monitoring the entire design, development, and construction process, including all construction documents. While this second level of project oversight by DAE follows strict federal guidelines, a project team experienced with the HUD process can anticipate particular requirements and minimize the additional time required to approve a HUD-financed project to less than 60 days.

Schematic design should only begin after a successful pre-application meeting is held with HUD and an FHA mortgage lender, the only party



that can make an FHA loan. The typical design timeline with HUD from start of the architectural narrative to delivery of HUD-approved construction documents can average 8-10 months. When handled by an experienced design and finance team, the FHA 242 process, from pre-application through approval, should average 7 to 9 months. Those processes run concurrently and should take a total of 8 to 10 months, although both could be affected by several factors, including project size and complexity.

Though the actual construction period is typically unchanged in a HUD-financed project, there is a required liquidated damages clause in the Construction Manager's Contract to compensate the hospital for costs resulting from a failure

to complete the project on time. To avoid the potential for liquidated damages, simply extend the schedule on paper but run a normal schedule on site.

One very positive aspect of the program is that HUD is continually reviewing its processes to streamline the effort required by applicants. Right now HUD is considering changes in the 242 program modeled on the expedited process in place for the agency's 232 loan insurance program covering housing for the elderly.

Cost considerations

Financing costs of an FHA 242 insured mortgage loan compare very favorably to available alternatives. Even at taxable rates, FHA-insured

direct loans still carry substantially lower interest rates than nonrated tax-exempt hospital revenue bonds, particularly in the current bond market. In general, all costs considered directly related to the project, including all financing costs and interest expense during the construction period, may be funded with mortgage loan proceeds. However, a certain amount of capital will be expended for preconstruction and design work, prior to the closing of the FHA-insured mortgage loan.

An experienced hospital mortgage banker will be able to provide the hospital with an accurate estimate of these funding requirements very early in the process and assist in determining if the hospital's internal resources will be sufficient. Keep in mind that many of these costs can be rolled into the loan amount because they are considered directly related to the project, but a certain amount of capital will be needed to fund preconstruction and design work.

The following outlines some of the critical steps in the project development and construction processes, along with a few tips to consider in evaluating use of the HUD 242 program.

During project development. The owner will need to coordinate with the program manager and hire professionals such as an FHA mortgage banker to manage the financing part of the process. The entire project team will need to be involved in the HUD pre-application meeting and the HUD site meeting at the hospital. (For critical access hospitals, these meetings may be combined.)

The site selection will need to be carefully evaluated. As the guarantor of project financing, HUD needs to be assured that the site is free of liabilities. Environmental assessments (Phase 1 and any subsequent evaluations), historical surveys, geotechnical investigation, noise pollution studies, a title insurance policy, documentation of proper zoning, the availability of all utilities, and very comprehensive ALTA (American Land Title Association) land surveys all may be required as part of HUD's evaluation process.

Drawings and specifications will need to meet the AIA's Guidelines for Design and Construction of Healthcare Facilities (2006 Edition), National Fire Protection Association Life Safety Code (2006 Edition), and ADA Guidelines (28 CFR 36 Revised July 1, 1994) under which HUD is currently reviewing projects, as well as all state/local agencies'

regulations. Even if your state does not use the same guidelines as HUD, your architect will need to review the design by both sets of standards and resolve any conflicts with both agencies.

The architect also needs to closely review DAE's 2.1 Guide for Project Applicants Design and Construction Related Activities and, if construction-managed, 2.4 Guide for Project Applicants Construction Management Services. These guidelines closely detail DAE's expectations for each phase of design: Schematic Design (Stage I), Design Development (Stage II), and Construction Documents (Stage III). Each of these phases requires a submission to the assigned DAE project manager. The mortgage banker can often assist the construction team by coordinating the submissions of drawings/specifications to HUD, along with associated financing components, to ensure consistency and avoid confusion among the various federal agencies involved in the FHA review process.

HUD/DAE typically takes 4 to 6 weeks to review and return comments for the design team's response. HUD will also offer review comments on the financial portion of the submission.

If the job is construction-managed, which is highly recommended, close coordination will be needed between the construction manager and architect to develop Division I of the construction specifications.

HUD requires open bidding on all construction trades. Specifications must list three manufacturers and consultants and include an "or approved equal" clause indicating that specification has been open to all manufacturers who qualify. Generally, DAE will not allow proprietary specifications. However, if your architect and mortgage banker can present a strong case that a particular project will benefit from using a particular product, exceptions can be approved.

HUD projects also require that all work for construction be included under the Owner-Architect Contract. Therefore, it is recommended that signage drawings, landscape drawings, food service drawings, etc., all be a part of the documents.

Alternates or allowances are not allowed on HUD projects, so your architect must be able to help facilitate decision making by hospital leadership regarding the scope of the project early in the process.

During construction. The principal of record will be required to attend each of the monthly

Owner-Architect Contractor (OAC) meetings or specifically designate an approved associate. A DAE project manager will also be in attendance and will prepare a progress report for HUD, required as a part of the pay application process for approving disbursement of funds. Thorough minutes of the OAC meetings by the architect can assist DAE in preparing an accurate progress report.

Special attention must be paid to the pay application process for a HUD project, as monthly pay application forms must be reviewed and approved by several different parties in different parts of the county before mortgage proceeds can be disbursed. Delays can be avoided when the construction manager or general contractor provides a complete and accurate pay application with complete back up, and the mortgage banker prepares an accurate mortgage loan draw request.

With HUD/DAE approval, the owner's contingency can be released for funding options or unforeseen expenses in construction—typically in an amount directly proportional to the percentage of the project that has been billed. This process for receiving approval for the use of contingency for change orders can also be accomplished relatively expediently if planned in advance; by understanding each step of the process and ensuring all submittals are correct the first time, timelines can be accelerated. Recently, for example, we were able to shorten a typical loan approval by half the standard time.

The HUD process is complex but finding experienced partners is the key to coordinating financing and design, and navigating federal, state, and local reviews. Done properly and efficiently, affordable financing that might not be available otherwise can be obtained. **HBI**

David J. Brown is managing principal of JJCA and has worked on seven major FHA 242 projects. Contact him at dbrown@jjca.com or phone 615.837.0656, or for more information visit www.jjca.com. Alan P. Richman is the President and CEO of InnoVative Capital, LLC, a HUD-licensed FHA mortgage bank specializing in financing FHA 242 mortgage insured hospital loans. Contact him at arichman@innovativecapital.com or phone 610.543.2490, x101, or visit www.innovativecapital.com for further information.