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Financial Information on HUD's Section 242 Hospital Mortgage Insurance Program

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The Honorable William Proxmire
Chairman, Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Fernand J. St Germain
Chairman, Committee on Banking, Finance, and Urban Affairs
House of Representatives

This report was prepared in response to Section 412(e) of the Housing and Community Development Act of 1987 (Public Law 100-242). This provision mandated a GAO study of the "long-term financial exposure of the Federal Government" under the Department of Housing and Urban Development's (HUD's) Section 242 hospital mortgage insurance program. This program insures loans for the construction and rehabilitation of hospitals. As of August 1988, the program had an inventory of 160 insured mortgages, with unpaid principal of approximately $4.5 billion.

In this report, we present information on the background and current financial status of the Section 242 program and HUD's estimate of future revenues and expenses arising from Section 242 mortgages.

Results in Brief

The Section 242 program is administered as part of HUD's General Insurance Fund, which had incurred a cumulative operating deficit of over $2.6 billion as of December 31, 1987. According to HUD's analysis of the fund's insurance reserves, this cumulative deficit will increase by an estimated $236.5 million in the future.[1] In contrast, HUD estimated that existing Section 242 mortgages would not contribute to this increase in the fund's cumulative deficit because these mortgages would produce a future operating surplus of $7.7 million. (See p. 6.)

HUD indicated, however, that if even a few hospitals with large mortgages were to default, the Section 242 program "could impose a serious burden on the fund." Of the 160 mortgages, 25 were at least $50 million each. Although only about 16 percent of the mortgages, these 25 accounted for about 60 percent, or about $2.7 billion, of the $4.5 billion

[1]The increase in the deficit is based on HUD's estimate of revenues and expenses from the insured mortgages in its inventory as of December 31, 1987, over the lives of all such mortgages. It does not consider the effect of any future mortgages HUD may insure.

in outstanding mortgage principal. A default on one or more of the larger hospital mortgages could quickly change the Section 242 insurance program from being a projected surplus to a deficit, and further increase the General Insurance Funds projected overall deficit.

Objectives, Scope, and Methodology

Our objectives were to obtain information on the financial condition of the Section 242 program, including the overall inventory of insurance in force[2] and the risk of financial losses to HUD from insurance claims by lenders when hospitals default on their mortgages.

The financial information in this report was provided by the accounting firm of Price Waterhouse, which obtained the data from HUD. Under contract with GAO, Price Waterhouse is currently conducting a financial audit and accounting systems review of the mortgage insurance funds administered by HUD's Federal Housing Administration (FHA). We supplemented this information with interviews we had with HUD and Department of Health and Human Services (HHS) officials. HHS processes insurance applications and monitors insured mortgages for HUD. The HUD data we obtained included records of Section 242 mortgages as of August 1988; information on defaulted mortgages; and an actuarial estimate by HUD as of December 31, 1987, including future revenues and expenses of the Section 242 program.

HUD's actuarial estimates, which covered all of its mortgage insurance programs, are based on several assumptions, including (1) the current amount of mortgage insurance in force; (2) the "ultimate claim rate," which is an estimate of the proportion of insurance in force that will result in insurance claims against HUD; (3) an estimate of the percentage of unpaid principal lost if HUD sells a mortgage or foreclosed property; and (4) an estimate of HUD's future administrative costs.

Price Waterhouse tested HUD's methodology for estimating future revenues and expenses in the Section 203(b) single-family housing program, but did not specifically review the actuarial assumptions underlying the Section 242 program. However, according to a Price Waterhouse official, HUD's basic estimating procedures are common to all of HUD's mortgage insurance programs. Price Waterhouse found the actuarial procedures "not unreasonable" as a means to estimate future changes in the financial position of HUD's mortgage insurance funds. However, Price Waterhouse noted a need for HUD actuaries to (1) update actuarial

[2]The insurance in force represents the unpaid principal for all mortgages insured by HUD.

assumptions more frequently, (2) improve the factoring of inflation into calculations of future administrative costs, and (3) improve the studies used to determine the percentage of mortgage principal lost when HUD sells a mortgage or a foreclosed property.

Our work was done between August and October 1988 in accordance with generally accepted government auditing standards.

The Section 242 Hospital Mortgage Insurance Program

Under Section 242 of the National Housing Act (12 U.S.C. 1715z-7), lenders are insured against financial losses if hospitals fail to make their mortgage payments. The Section 242 program is part of the General Insurance Fund, which is administered by FHA. This fund also includes several mortgage insurance programs for single-family and multifamily housing and for nursing homes. The General Insurance Fund obtains revenues from mortgage premiums paid by lenders and the proceeds of sales of mortgages and foreclosed properties. It incurs expenses for administration, payments of insurance claims, and costs of maintaining and selling foreclosed properties.

A hospital applies to HHS for insurance. After reviewing the application and determining the feasibility of the project, HHS recommends approval or disapproval of insurance to HUD. If HUD approves the insurance application, it makes an initial commitment to insure the mortgage, after which the hospital begins its construction or rehabilitation project.[3] Section 242 mortgages are for terms of not more than 25 years.

Hospitals that are unable to meet monthly mortgage payments within 30 days of their due dates are considered in default. HHS staff work with these hospitals to resolve their financial problems, so they can resume their monthly payments. If efforts to resolve a default fail, the lender notifies HUD of the default, then files a claim for insurance. With the insurance claim, the lender will either assign the mortgage to HUD or foreclose on any property involved with the project and transfer the title to such property to HUD.

According to HUD and HHS officials, lenders will normally elect to assign mortgages to HUD, rather than foreclose on the hospital's property. If the mortgage is assigned, HUD pays off the unpaid mortgage principal and

[3] HUD's initial commitment sets out the terms and conditions for insuring a mortgage. Once the construction or rehabilitation project is completed and all of HUD's requirements are met, HUD will formally insure the mortgage.

becomes, in effect, the lender. HUD then attempts to restructure the mortgage so that it may be reinstated, with the hospital resuming monthly payments. If the lender forecloses by itself and transfers title to HUD, or if efforts to restructure an assigned mortgage fail, HUD may sell the property associated with the project.

HUD's Inventory of Section 242 Mortgages

As of August 1988, 160 Section 242 hospital mortgages were in force, with original principal totaling over $4.7 billion (see table 1) and unpaid principal totaling about $4.5 billion. The average original mortgage was for $29.6 million, but mortgages ranged from $278,000 to $388 million. For many mortgages, little or no principal has been paid because (1) the hospital project has not yet been completed or (2) the hospital has made few payments, and most of the amount paid has been for interest.

Although the Section 242 program began in 1969, about three-quarters of existing insurance in force is in mortgages for which HUD made its initial insurance commitment after 1979. Also, the average size of new mortgages has increased greatly since 1979. As seen in table 1, about 57 percent of the original principal of mortgages in force as of August 1988 is concentrated in 25 mortgages of $50 million or more. Only 3 of the 25 mortgages involved initial commitments by HUD before 1980.

Table 1: Section 242 Hospital Mortgages, by Total Mortgage Amount, as of August 1988

Dollars in thousands

Original mortgage principal	Number of mortgages	Percent of total mortgages	Original principal	Percent of total principal
$100 million or more	8	5.0	$1,560,421	32.9
$50-$99 million	17	10.6	1,161,586	24.5
$25-$49 million	30	18.8	997,121	21.0
$10-$24 million	46	28.8	748,718	15.8
$5-$9 million	28	17.5	2,015,906	4.3
Less than $5 million	31	19.4	73,595	1.6
Total	**160**	**100.1[a]**	**$4,743,347**	**100.1[a]**

[a]Percentages do not add up to 100.0 percent due to rounding.

The federal government's financial exposure for existing mortgages will end in 2017, when the last of these mortgages will mature. Most of the outstanding principal for the mortgages in force as of August 1988 is in mortgages that will mature between 2010 and 2017, as shown in table 2.

Table 2: Section 242 Hospital Mortgages as of August 1988, by Maturity Year

Dollars in thousands

Calendar year mortgages reach maturity[a]	No. of mortgages maturing	Unpaid principal
Before 2000	22	$81,031
2000-2004	37	342,727
2005-2009	47	916,712
2010-2014	46	1,985,203
2015-2017	8	1,146,741
Total	**160**	**$4,472,414**

[a]Maturity year means the year in which the mortgage is fully paid off by the hospital.

Section 242 Mortgages in Default

Six of the 160 mortgages in force as of August 1988 were in default, totaling about $67 million in potential claims against HUD by lenders. In four of the six cases, however, HUD expects the mortgages to be reinstated and the hospitals to resume payments. In the other two cases, HUD expects that defaults will result in insurance claims totaling about $19 million. The six mortgages had unpaid principal balances ranging from $4.4 million to $16.8 million and averaging $11.1 million.

In two of the six current defaults, the lender has notified HUD that it plans to assign the mortgage to HUD, but has not yet done so. HUD doubts that one of these two mortgages, with unpaid principal totaling $13.6 million, can be reinstated. Of the four cases where the lender has not told HUD that it plans to assign the mortgage, HUD expects three to be reinstated. (See table 3.)

Table 3: Defaulted Section 242 Mortgages, as of August 1988

Dollars in thousands

Mortgage	Unpaid principal	Lender elected to assign mortgage to HUD[a]	HUD's prognosis for reinstatement of mortgage
A	$11,158	No	Expected
B	15,118	No	Expected
C	4,376	No	Expected
D	5,523	No	Doubtful
E	16,825	Yes	Expected
F	13,561	Yes	Doubtful

[a]An "election to assignment" is the lender's notification that it intends to assign a mortgage to HUD.

HUD's Estimate of Future Revenues and Expenses From Section 242 Mortgages

As of December 31, 1987, HUD's General Insurance Fund had incurred a cumulative operating deficit of over $2.6 billion. In an actuarial analysis, HUD estimated that, over the lives of mortgages in HUD's inventory as of December 31, 1987, administrative costs and insurance claims would exceed premiums and other revenues by $236.5 million. This would increase the cumulative General Insurance Fund operating deficit to almost $2.9 billion. HUD's analysis, however, indicates that the Section 242 program will not contribute to increasing the fund's deficit. HUD estimates that the Section 242 mortgages in force as of December 31, 1987, will produce an operating surplus of $7.7 million.

Insurance fund revenues include premiums paid by lenders to HUD, sales of foreclosed properties, and monthly payments from hospitals and other borrowers for mortgages assigned to HUD. Expenses include (1) payments of lenders' insurance claims; (2) administrative expenses; and (3) taxes, maintenance costs, and sales expenses on foreclosed properties owned by HUD.

In preparing its actuarial estimates, HUD assumed that 24.9 percent of the unpaid principal balances of Section 242 mortgages with initial insurance commitments in calendar years 1969-73 will be paid by HUD to lenders for insurance claims. It assumes that only 8.6 percent of the balance for mortgages with initial insurance commitments in calendar years 1974-87 will be paid as claims, because HUD's analysis assumes that there will be fewer claims on post-1973 mortgages. For claims that end with HUD acquiring a mortgage or title to property, HUD assumes that it will lose 63 percent of the unpaid principal balance if it sells the mortgage or property. Using the assumptions noted above, HUD estimates future Section 242 revenues of $138.4 million in premiums and claim recoveries. This amount would more than offset the estimated $130.7 million in future claims and administrative expenses.

HUD's estimates for the Section 242 program are subject to wide variations, the analysis cautions, due to the sizes of insured hospital mortgages. As of August 1988, a large proportion of the outstanding mortgage principal was in relatively large mortgages. Thus, defaults on a few large Section 242 hospital mortgages could lead to insurance claims that, as HUD's analysis notes, "could impose a serious burden" on the General Insurance Fund.

Also, according to the HUD analysis, the risk of insurance claims is greatest in the first 7 years of repayment, and during this period more claim-related expenses are incurred than for older inventories. Of HUD's

Section 242 inventory, 55 of the 160 outstanding mortgages, totaling about $2.7 billion in unpaid principal, have been insured within the last 7 years.

As agreed with your offices, we did not request formal comments from HUD on this report, but we discussed matters in this report with HUD officials and incorporated their comments where appropriate. We are sending copies of this report to interested parties, and will make copies available to others on request. This report was prepared under the direction of Linda Morra, Associate Director. Other major contributors are listed in appendix I.

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