



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Date: June 20, 2023

Mortgagee Letter 2023-12

To: All Federal Housing Administration Approved Section 242 Lenders

Subject Eligibility of Outstanding Borrower Debt to be Refinanced with Insured Mortgage Proceeds Pursuant to Section 242 of the National Housing Act (Section 242, Section 241, and Section 223(f))

Purpose This Mortgagee Letter clarifies existing guidelines regarding the eligibility of outstanding borrower¹ debt to be refinanced with a loan pursuant to Section 242 of the National Housing Act. This letter will enable Lenders to evaluate debt eligibility when preparing Pre-Applications or Applications for mortgage insurance under the Section 242 program.

Effective Date This Mortgagee Letter is effective immediately upon issuance.

Affected Policy <https://www.ecfr.gov/current/title-24/subtitle-B/chapter-II/subchapter-B/part-242>
https://www.hud.gov/program_offices/administration/hudclips/handbooks/hsg/4615.1

Background The Department of Housing and Urban Development’s (“HUD”) Office of Hospital Facilities regularly receives Pre-Applications and Applications for projects that include a refinancing component. Existing guidance limits the eligibility of borrower debt-to-be-refinanced through the definition of Capital Debt and the definition of Refinancing found in 24 CFR § 242.1 and set forth below:

Capital Debt means the outstanding indebtedness used for the construction, rehabilitation, or acquisition of the physical property and equipment of a Hospital, including those financing costs approved by HUD.

¹ The term “borrower” shall be synonymous with the term “mortgagor” as both terms are used in 24 CFR Part 242 and the Section 242 closing documents. A borrower or mortgagor is an eligible entity seeking an FHA-insured loan through the Section 242 program.

Refinancing means the discharging of the existing Capital Debt of a Hospital through entering into new debt.

HUD uses three key tests to establish whether a borrower's debt, proposed to be refinanced with proceeds from a loan insured through the Section 242 program, meets the definition of Capital Debt and is eligible to be refinanced:

1. Were the proceeds from the debt originally used exclusively for the construction, rehabilitation, and/or acquisition of physical property and equipment of the borrower's Hospital, including those financing costs approved by HUD?
2. Is the borrower the sole or principal obligor on the debt?
3. Since its original issuance, has the debt been a liability of the borrower?

HUD executes this Capital Debt eligibility determination by first reviewing the audited financial statements of the borrower. Review of the audited financial statements should allow HUD to establish the borrower as the obligor on the debt, as well as trace the debt to its "original issuance" (i.e. the issuance where loan proceeds were directly used for capital purposes). Once the original issuance date is established, HUD reviews the related Offering Statements and/or similar executed closing documents. These and other submitted documents are used in conjunction with the audited financial statements to determine whether loan proceeds were used for construction, rehabilitation, and/or acquisition of physical property and equipment and whether that borrower originally incurred the debt. HUD then, if applicable, will trace all subsequent refinancings of the original issuance to ensure that the proceeds of each refinancing met Capital Debt eligibility requirements, and that the borrower has remained the obligor on the debt since the original issuance.

Guidance

To clarify Capital Debt eligibility requirements, HUD notes the following:

In order for outstanding debt of a borrower to be classified as Capital Debt, eligible to be refinanced under Section 242 mortgage insurance programs, the debt must meet the following criteria:

The debt must:

1. Have been originated and continuously held by the borrower

Mortgagee Letter 2023-12, Continued

2. Have been used exclusively for
 - a. An eligible capital project at a Hospital and/or ancillary properties associated therewith that are wholly-owned by the borrower, and will be pledged to the FHA Lender as collateral for the FHA-insured loan, and/or
 - b. A refinancing of the borrower's debt used exclusively for the purposes listed in 2(a), and that meets the criteria in (1) above.

An "eligible capital project" includes one or more of the following: Construction, rehabilitation, acquisition of land, physical property and/or equipment, and those financing costs approved by HUD.

"Originated and continuously held" means that the borrower was the sole or principal obligor on the original issuance of the debt and all subsequent refinancings of the issuance, and the debt has continued to appear as an outstanding obligation on the borrower's audited financial statements since its original issuance.

HUD does not specifically limit the number of times that Capital Debt can be refinanced by the borrower prior to applying for FHA mortgage insurance. However, HUD considers various factors when making loan sizing, loan term, and commitment decisions, including, but not limited to, the useful life of the assets securing the loan and the credit quality of the borrower.

If an Application or Pre-Application includes a refinancing component, it is the Lender's responsibility to ensure that the proposal demonstrates, through clear and official documentation, that the debt-to-be-refinanced meets the criteria detailed within this Mortgagee Letter. Official documentation must include the audited financial statements of the borrower (including income statements, balance sheets, cash flow statements, and notes to the financial statements) that show the debt continued to be recorded as an outstanding liability of the borrower from its original issuance to the present day. The official documentation must also include origination documents (Offering Statements, executed closing documents, etc.) that include sources and uses data for the original issuance, as well as for any subsequent refinancings of that issuance. These documents must establish that the original issuance was used for eligible capital projects.

HUD, at its sole discretion, may determine that only a portion of the outstanding debt meets the definition of Capital Debt. To make this determination, HUD may require analyses from independent third-party auditors and/or legal counsel that quantify the current portion of the debt

Mortgagee Letter 2023-12, Continued

that is attributable to eligible capital projects. In these cases, the borrower must retire the non-eligible portion of the debt at or prior to initial endorsement (in the case of insurance of advances) or initial/final endorsement (in the case of insurance upon completion).

Examples of Capital Debt include, but are not limited to, the following:

1. Borrower debt that was originally used to construct a replacement Hospital facility, plus financing costs, where that original issuance was refinanced in subsequent years.
2. Debt of a borrower's subsidiary (where the subsidiary is wholly-owned and operated by the borrower and wholly-obligated under the proposed FHA-insured mortgage) where the proceeds of the original debt were used for a construction project at a Hospital owned by that subsidiary.
3. Borrower debt that only partially meets the requirements to be classified as Capital Debt, and the borrower has the liquid assets to retire the non-eligible portion via its own equity at or prior to initial endorsement of a Section 242 or 241 loan.

Examples of debt or liabilities that do not meet HUD's Capital Debt requirements include, but are not limited to, the following:

1. Borrower debt, originally used for operating purposes or for projects unrelated to the Hospital(s) included as collateral for the loan.
2. Debt of an entity other than the borrower or its wholly-owned subsidiaries that are or will be securitized by the FHA-insured mortgage.
3. Debt that was originated by an entity other than the borrower or its wholly-owned subsidiaries that are or will be securitized by the FHA-insured mortgage, that subsequently became or will become an obligation of the borrower or a subsidiary prior to initial/final endorsement of a Section 223(f) refinancing loan.
4. Borrower liabilities obligated via a guarantee of another entity's debt.
5. Debt of a borrower where the proceeds were used for construction, rehabilitation, and/or acquisition of land, physical property and/or equipment of an entity other than the borrower or its wholly-owned

Mortgagee Letter 2023-12, Continued

subsidiaries that are or will be securitized by the FHA-insured mortgage.

6. Debt of a borrower that cannot be conclusively tied to construction, rehabilitation, and/or acquisition of land, physical property and/or equipment of the borrower or its wholly-owned subsidiaries that are or will be securitized by the FHA-insured mortgage.

Questions

Any questions regarding this Mortgagee Letter may be directed to the Office of Hospital Facilities by email at Hospitals@hud.gov.

Signature

Julia R. Gordon
Assistant Secretary for Housing –
FHA Commissioner
