As described in a previous publication, the 2017 Tax Cuts and Jobs Act eliminated advance refundings on a tax-exempt basis (see sidebar). While many borrowers achieved economically attractive advance refunding of most Series 2008 and 2009 bonds prior to tax reform taking effect, the next “bite at the savings apple” for most borrowers will be a current refunding of their tax-exempt fixed-rate bonds issued in 2010 and later.

Hospital borrowers should begin to map out their market plans for these upcoming current refundings and should consider other options available to them to lock-in rates and/or capture savings in advance. This may be particularly true as borrowers start to think more broadly about any new-debt issuance needs and the restructuring of bank direct purchases, whose terms may have changed (i.e., costs increased) with a decrease in the corporate tax rate.

Described here are the reasons why refundings typically make sense for hospitals, how best to plan for an upcoming issuance, and six alternatives that finance/treasury executives can employ to access refunding savings for their previously tax-exempt advance refundable bonds.

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**Refundings in Context**

Historically, not-for-profit hospitals have used refundings to lower overall borrowing costs for their fixed-rate bonds on or before the call date in advance of the maturity date. Tax-exempt fixed-rate bonds typically have a 10-year call option, providing borrowers with the ability to redeem the bonds at their discretion.

Under the tax laws in effect from 1986 to 2017, borrowers could “advance refund” bonds more than 90 days prior to the call date, one time, by issuing new tax-exempt debt and funding an escrow with highly rated securities that released on the call date to redeem the prior bonds.

Refinancing less than 90 days prior to the call date or thereafter is a “current refunding,” which also was and remains an option.

Borrowers cannot use tax-exempt advance refundings now, but must wait to access savings until the current refunding period or use alternative strategies described in this article.

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2. This paper also has application for the still-outstanding, tax-exempt fixed-rate bonds issued in the second half of 2009, with a call date that has not reached the 90-day current refunding window.
Why Refundings Make Sense

Refundings remain an attractive tool for capital structure management now for the following three reasons:

**Interest rates remain near historic lows.** In 2010 and 2011, hospital borrowers issued the majority of their fixed-rate bonds with 5 percent coupons. Today’s flat and low yield curve enables borrowers to lock in considerably lower yields if they decide to act now, creating cash flow and/or present value savings. Figure 1 illustrates the downward trend of both the fixed municipal market rate (MMD) and synthetic 20-year LIBOR (floating) swap rate. Both traditional and synthetic fixed rates remain near historic lows.

**FIGURE 1. 20-YEAR TERM MMD AND 68 PERCENT LIBOR SWAP RATES REMAIN ATTRACTIVE**

*Source: Bloomberg data as of Feb. 27, 2019.*

<table>
<thead>
<tr>
<th>68% 20Y LBR</th>
<th>20Y MMD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
<td>2.95%</td>
</tr>
<tr>
<td>Current</td>
<td>1.93%</td>
</tr>
<tr>
<td>% of Time Lower</td>
<td>23.66%</td>
</tr>
</tbody>
</table>

**Rolling down the yield curve lowers costs.** A current refunding of a 30-year bond issued in 2010 is today a 20-year bond, enabling its replacement by a 20-year yield. The reference point for quoting relevant rates relies on the average life for a bond, which is less than its final maturity. However, indicative rates for these maturities illustrate the point. For reference, 30-year MMD in 2010 was 4.16 percent, compared with 20-year MMD of 2.79 percent as of Feb. 27, 2019.

**Not-for-profit healthcare credit spreads remain attractive.** In addition to base interest rates for fixed-rate bonds (MMD index), credit spreads for not-for-profit borrowers have recovered significantly since 2010-2011, as noted in Figure 2. This is a result of market recovery following the 2008-2009 credit crisis and the general level of interest rates.

The sample analysis appearing in a table later suggests that borrowers have a variety of economically attractive alternatives for pursuing refunding savings on outstanding bonds.
**Six Strategies to Capture Refunding Savings**

Borrowers can elect to wait until the call date (or 90 days prior) to do a current refunding of their fixed-rate bonds or implement alternative refunding strategies at any time. While we describe the general structure of each alternative below, the trade-offs with these six strategies require an in-depth analysis based on the organization’s unique capital structure goals and objectives.

1. **Wait and Refund on a Current Basis**
   Hospitals can wait until 90 days before the call date for current refunding on a fixed-rate tax-exempt basis, but need to start early with refunding planning. Borrowers continue to carry interest-rate risk until that point, but the makeup of the resulting refunding bond is unchanged relative to the refunded bond.

2. **Refund on a Taxable Basis**
   Not-for-profit hospitals can advance refund prior bonds on a taxable basis today or at any time. Depending on the hospital borrower’s credit and prevailing market conditions, taxable bonds may result in attractive present value savings. A taxable refunding today eliminates the interest-rate risk associated with waiting to refund the prior bonds at the call date and is free of the federal tax code limitations regarding allowable ownership and use.

   Taxable bonds, however, have different market features that generally restrict some of the flexibility afforded by the tax-exempt fixed-rate market. For example, taxable bonds generally have bullet maturities and a make-whole call feature instead of the level debt amortization and 10-year par calls more available in the tax-exempt fixed-rate market. Any deviation from the market standard typically results in lowered liquidity and higher spreads.

3. **Issue a Tax-Exempt Forward Delivery Bond**
   A forward delivery bond is a contract with a capital markets participant (e.g., investment bank, placement agent) to issue a refunding bond at a certain date in the future. The yield curve is driving pricing lower for forward bonds and swaps. The flatter the curve, the lower the pricing. A new forward delivery bond, which borrowers can secure in the public market or privately with a direct lender, is priced with a delivery date sometime in the future and coordinated with the call date of the refunded issue. In this way, a forward delivery bond removes interest rate risk by locking in today’s rate while waiting for the call date, but at a premium to a standard bond transaction.
4. Issue a Forward Starting Swap
Entering into a forward starting, floating-to-fixed interest rate swap in advance of the call date allows the borrower to lock in today’s interest rates, with swap cash flows that commence on or near the call date. When implementing this strategy, the borrower also plans to issue tax-exempt variable-rate current refunding bonds on the call date when the swap cash flows begin.

Today’s flat yield curve, as evidenced by the differential curve between 2-year and 10-year LIBOR swap rates, indicates that forward premiums are inexpensive on a historic basis, thereby making forward strategies attractive today (Figure 3).

FIGURE 3. YIELD CURVE STEEPNESS AS PROXY FOR FORWARD PREMIUMS
Source: Kaufman, Hall & Associates, LLC.

<table>
<thead>
<tr>
<th>10Y - 2Y LBR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average</td>
</tr>
<tr>
<td>Current</td>
</tr>
<tr>
<td>% of Time Lower</td>
</tr>
</tbody>
</table>

Risks associated with this approach include those associated with any swap transaction (e.g., collateral posting, counterparty risk, negative mark-to-market valuation) as well as market-access risk at the time of the call date. Although this approach changes the risk profile of the underlying obligation, it likely maximizes the economic savings available from a refunding. A thoughtful discussion and analysis of this approach should occur before its pursuit.

5. Issue a “Cinderella” Bond
Typically done through a direct purchase from a bank, Cinderella bonds initially are issued as taxable debt, but subsequently convert on the call date to tax-exempt bonds bearing a lower predetermined tax-exempt rate. Major considerations include the following: requirements for tax diligence; issuance of a tax-exempt bond opinion at the time of tax-exempt conversion; general availability of this product from banks; and the commitment period offered, which may be shorter than the final maturity of the bond. This alternative may be attractive for borrowers who do not otherwise have plans to access public markets to issue debt in the next two years but want to capture the economics available in the current market to lower their cost of debt for the period of the bank commitment.

6. Use a Rate Lock
These tools are available in many forms, allowing organizations to hedge the risk of a rising interest rate while waiting for the call date. Organizations can use different indices—for example, MMD, SIFMA, and Treasury-rate locks—to accomplish different strategies. Cash settlements occur at the call date.
What Savings Are Possible?

As an example, the table below illustrates refunding savings for five strategies described here, assuming an “A” rated healthcare organization that issued in 2010 a 30-year bond for $100 million with a 5 percent coupon, final maturity in 2040, and a call date of June 2020.

Data appear from lowest to highest net present value savings by strategy. As discussed earlier, each strategy carries different implications for an organization’s capital structure and specific needs. Alternatives should be evaluated carefully.

<table>
<thead>
<tr>
<th>Net Present Value Savings</th>
<th>Forward Delivery Bond</th>
<th>Taxable Bond</th>
<th>Current Refunding</th>
<th>Cinderella Bond</th>
<th>Forward Starting Swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollars in Millions</td>
<td>$2.8</td>
<td>$4.2</td>
<td>$11.9</td>
<td>$15.7</td>
<td>$25.9</td>
</tr>
<tr>
<td>Percentage</td>
<td>2.8%</td>
<td>4.2%</td>
<td>11.9%</td>
<td>15.7%</td>
<td>25.9%</td>
</tr>
</tbody>
</table>

Assumptions:
2. For current refunding scenario, assumes interest rates do not change between now and the call date.
3. Cinderella bond savings presented in the table are for the first 10 years only; assumes a 10-year bank direct purchase commitment, which introduces price and renewal risks at the renewal date; commitment period will vary by bank and may be shorter than the final maturity.
4. Forward starting swap assumes 70 percent of LIBOR floating leg and 1.10 percent dealer spread and credit support charge.

Next Steps

First, revisit your organization’s overall treasury and capital markets goals. Key questions include:

- Are there pressing capital needs now or in the near future?
- Do broad organizational goals related to performance improvement initiatives make it preferable to access available savings sooner than the call date?
- Is interest-rate risk of particular concern between now and the call date?
- Does the organization have an appetite for derivative-based alternatives?

Responses to these questions and others often will dictate the best course of action as borrowers begin to formulate a plan.

Second, revisit your tactical capital structure objectives for fixed-to-variable debt mix targets. It may be possible to adjust the mix without adding new-money debt to the portfolio. Selecting the appropriate relationship of fixed-rate and variable-rate debt is one of the most important capital structure decisions made by an organization’s financial leaders. Achieving the right mix requires planning, timing, and proper execution.

3. The rate lock strategy would not provide an apples-to-apples comparison with other strategies, so it is not included here.
Third, **reevaluate other capital structure needs, terms, and relationships** with commercial and investment banks and other capital sources. For example, pricing for variable-rate direct bank purchases, made by hospital borrowers prior to 2018, likely increased due to contractual provisions related to the new tax law. Other alternatives in the public market or other forums may be less expensive now and worth pursuing in conjunction with other capital structure/restructure needs. Depending upon the business relationship, banks may be willing to revise their pricing while the organization waits to enter the market or restructure debt in other ways.

Fourth, **when entering the market, pick a schedule that makes sense for the organization**. For example, consider other milestones, such as financial audit release timing, recent financial performance, new-money needs, or other debt-restructuring goals. Upcoming capital structure events, such as a mandatory tender of a put bond or the rollover of a floating-rate note, represent a ripe time for refunding consideration.

Fifth, **begin the planning process early**. The evaluation of overall capital structure needs and relationships described here takes time and likely includes consideration of many factors, including maturity, put, renewal, and call dates. Current refundings can occur 90 days in advance of call dates, so executives should start planning four to six months in advance of that date.

### How to Pick a Strategy

As with any capital structure decision, a hospital borrower should employ rigorous analysis of each of the options described here and their implications for the organization’s specific situation and risk appetite. Various factors influence the decision of whether a solution is suitable, including investor demand, tax-exempt supply, taxable/tax-exempt ratios, and concerns about interest rate and other risks.

Options are available to meet refunding needs; however, each comes with different considerations relative to the organization’s current capital structure. The options are complex, so we recommend that hospital executives discuss alternatives with their financial advisor, who can quantify savings opportunities and related risks.

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