implications of the Federal Reserve’s actions for healthcare borrowers

Expected Federal Reserve interest rate hikes will have several impacts on healthcare borrowers, which can use a range of strategies in response.

The Federal Reserve’s actions have long had a significant impact on worldwide markets, including the municipal and other debt markets accessed by hospitals and health systems. Intended to maximize U.S. employment and price stability, what the Fed does can improve or impair the performance and risk of an organization’s capital structure.

In December 2015, the Federal Reserve announced that it would increase the target range for the Federal Funds Rate to 0.25 to 0.5 percent.

This benchmark is the short-term interest rate at which commercial banks lend to each other on loans they receive from their regional Federal Reserve Bank’s lending facility. Since 2008, the Fed has held the rate at 0 to 0.25 percent, reflecting its effort to inject dollars into the economy through low rate short-term borrowing by banks from the Fed, followed by new loans to consumers and companies from banks.

Additional gradual upward adjustments of the rate can be expected as the economy improves. The Fed may use a series of 25 to 75 basis-point increases over a multiyear period to get the rate to an as-yet-unstated level—one that would be deemed appropriate for a well-functioning economy, perhaps around 5 percent.

Different interest rate scenarios and the changing shape of yield curves affect the cost of capital and,

FLOATING-TO-FIXED SWAP

| Bondholders | Variable Cost of Funds | Health System | Fixed Payment | Counterparty | Variable Payment |

Source: Kaufman, Hall & Associates

Also known as “fixed-payer swaps,” floating-to-fixed swaps can be used to achieve a lower fixed rate of debt than would be achievable through issuance of traditional tax-exempt fixed-rate bonds.
therefore, the effectiveness of interest rate swaps and other derivatives. These tools historically have been used to manage capital costs. Health-care finance leaders should take time to understand the potential impact of current rate trends on various swap instruments and risk-hedging strategies, as well as organizational balance sheets and income statements.

Floating-to-fixed rate swaps, also known as “fixed-payer swaps,” can be used to achieve a lower fixed rate of debt than would be achievable through issuance of traditional tax-exempt fixed-rate bonds. A hospital borrower with variable-rate debt contracts with a swap counterparty (i.e., an investment firm or bank) to provide the hospital with variable payments (based on a defined index) over the life of the swap. In exchange, the hospital provides the swap counterparty with fixed payments.

If the borrower is willing to assume tax risk, this index is typically a percentage of the taxable benchmark, the London Interbank Offered Rate (LIBOR). In the extreme, if tax risk were to go away, then the variable payment (percentage of a taxable index such as LIBOR) received by the health system will not increase, but the tax-exempt variable payment from the health system to bondholders will go to a taxable rate. This tax risk, in addition to some other inherent risks underlying the structure when compared with traditional fixed-rate bonds, results in a lower cost of capital.

Alternatively, the borrower can use the Securities Industry and Financial Markets Association (SIFMA) index, which will track the tax-exempt variable-rate payment on the bonds more closely and not add tax risk. Risks inherent in the underlying variable-rate funding vehicle, such as bank renewal risk related to the underlying variable-rate bonds, will be assumed by the borrower under either arrangement.

If interest rates now start and continue to rise, the value of floating-to-fixed rate swaps held by health systems since the major meltdown generally will increase, depending on the average life of the outstanding swaps. Organizations with too much fixed exposure overall, and a break-even position on their swaps, may wish to consider simply unwinding them.

Due to the lower historic costs of variable rates, many hospitals have been seeking additional exposure to them. In recent years, issuing variable-rate demand bonds (VRDBs) with bank support provided the lowest cost, so organizations issued new money or refunded fixed-rate bonds with VRDBs.

There will be points in time where fixed-to-floating swaps provide the lowest cost and should be considered. With these “fixed-receiver swaps,” a hospital with fixed-rate debt contracts to receive fixed-rate payments from a swap counterparty over the life of the swap in exchange for providing the counterparty with variable-rate payments.

**FIXED-TO-FLOATING SWAP**

<table>
<thead>
<tr>
<th>Bondholders</th>
<th>Fixed Cost of Funds</th>
<th>Health System</th>
<th>Variable Payment</th>
<th>Fixed Payment</th>
<th>Counterparty</th>
</tr>
</thead>
</table>

Source: Kaufman, Hall & Associates

Also known as “fixed-receiver” swaps, fixed-to-floating swaps allow a hospital with fixed-rate debt contracts to receive fixed-rate payments from a swap counterparty over the life of the swap in exchange for providing the counterparty with variable-rate payments.
With the short end of the interest rate curve going up based on the Fed’s most recent actions, the cost of the health system’s variable-rate exposure would be the fixed rate on its bonds offset by the fixed rate that it receives with the swap and the variable rate it pays. The variable rate payment would be the variable rate index plus the spread between the fixed rate on the bonds and the fixed rate that it receives on the swap.

Fixed-to-floating swaps with three- to seven-year terms, rather than the longer positions that got hospitals into trouble with the floating-to-fixed rate swaps in 2008–09, will start to become more appealing to some organizations. Shorter trades can significantly reduce the volatility of mark-to-market movement. Another current appeal for fixed-to-floating swaps is that they reduce risk related to bank credit support because the underlying bond structure, namely fixed-rate bonds, is committed rather than bank-supported capital. Large organizations that may be running out of variable-rate credit support options may be able to lower their cost of capital and overall risk through use of fixed-to-floating swaps.

**Advance Refundings**

An advance refunding, which is a bond issuance used to pay off another outstanding bond, may be affected by rising short-term interest rates.

As the Fed continues to raise rates, finance executives should start working with their advisers to monitor the impact on a refunding from both a present-value savings and negative arbitrage standpoint. When rates rise, organizations may be able to buy escrow securities that are effectively equal to the average bond yield on the new bonds, so there’s zero negative arbitrage or a “perfect escrow,” increasing the present value savings that can be obtained via the advance refunding.

**Overall Risk**

Risk and risk relationships should continue to dominate capital structure decision making to ensure the lowest cost of capital at a risk acceptable to the organization. But finance leaders also must think about capital structure within the context of broader enterprise risk, which includes assets and liabilities, as well as operations. Consideration of any of these in isolation could negatively affect the organization’s overall risk.

Looking long and hard at every financial decision to assess its impact on the organization is recommended. Will the organization be enabled or hindered in its ability to pursue its mission and strategy with enough flexibility to respond to changing market conditions and healthcare’s shifting care delivery and payment environment? Being conservative with investments or debt structure might make room for incurring more risk in operations.

In a rapidly changing environment, enterprise risk analytics enable organizations to better achieve a positive overall impact with all strategies related to operations, asset-side investments, and liability-side debt, including swaps and advance refundings. Use of such sophisticated tools is strongly recommended.

Ryan Freel is a senior vice president, Kaufman, Hall & Associates, LLC (rfreel@kaufmanhall.com).

Eric A. Jordahl is a managing director, Kaufman, Hall & Associates, LLC (ejordahl@kaufmanhall.com).