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variable rate debt option in a changing market

Healthcare finance executives should be assessing variable-rate options for future financings and for the optimal diversification of variable-rate products in their organizations' current portfolios, given fixed-rate debt and the liquidity of investment holdings.

With the Federal Reserve's benchmark interest rate held to near zero for seven years, fixed-rate debt continued to dominate healthcare borrowing in 2016. Historic low rates induced many hospitals and health systems to issue fixed-rate bonds to finance capital needs, refinance outstanding fixed-rate bonds for savings, and in some cases, refinance variable-rate debt.

The exhibit on page 73 shows the proportion and amount of fixed- and variable-rate debt issued from 2007 to 2016. In 2016, a higher-than-ever 88 percent of debt ($38.8 billion) was fixed; 12 percent ($5.4 billion) was variable. Overall, during the past decade, 69 percent of nearly $360 billion of issued debt was fixed rate and 31 percent was variable rate.

In December, the Fed raised its benchmark rate a quarter of a percentage, and signaled that additional gradual adjustments of the rate upward can be expected during the year as the economy improves. Whether interest rates are increasing or decreasing, however, history continues to support the expectation that variable-rate instruments *will cost less over time* than fixed-rate alternatives. The exhibit on page 74 shows that over a 15-year period, the variable-rate index for tax-exempt debt (Securities Industry and Financial Markets Association [SIFMA]) was lower than the benchmark fixed-rate index for tax-exempt debt (Municipal Market Data [MMD]) in most years—and at many points considerably lower.[a] This has especially been true in the years following the credit crisis.

Variable-rate debt is a proven cost-saving strategy for healthcare borrowers—*when* its risks are appropriately assessed and managed within the organization's capital structure, credit, and overall risk profiles. Because variable-rate interest cost savings remain substantial in the current market, a larger proportion of variable-rate debt financing might be expected in 2017.

Healthcare borrowers should be contemplating how much variable-rate debt and what types of such debt their organizations should be carrying.

Analysis Required

Numerous factors play a significant role in determining an appropriate variable-rate exposure target for an organization and suitable products for that target. Analyses should include factors such as an organization's credit profile, size, investment liquidity, performance trend, existing capital portfolio, and overall risk tolerance enterprisewide. Organizations with

a. The spike that occurred in 2007 was due to lack of liquidity in the tax-exempt variable-rate demand bond market caused by the credit crisis. During this timeframe, the subprime mortgage crisis and the resultant meltdown of the insurer-backed municipal auction-rate securities market forced borrowers back into the market to secure alternate variable-rate financing options.

multibillion dollar revenues and higher credit ratings may be able to carry the perceived risk of a larger proportion of variable-rate debt in their debt portfolio than can other organizations with lower revenues and ratings. Changing tax rates, regulation, and capital lending requirements with the new administration could affect the level and type of risk of particular products. A strong understanding of the shifting risk dynamics with each product and their combinations, a thorough risk assessment, and development of risk-mitigation strategies are recommended.

Risks Versus Rewards

Like fixed-rate options, variable-rate debt is accessed through public or private instruments, with much of the recent healthcare activity occurring in the direct-purchase bank setting. Interest rates reset on a periodic basis to a predetermined formula or defined index, most often adding a borrower-credit-related spread off a percentage of LIBOR (London Interbank Offered Rate) as a proxy for SIFMA.

For many organizations, a convenient, cost-efficient way to use variable-rate debt is with new-money projects with longer established drawdown schedules. Using variable-rate debt allows borrowers to incur a lower cost loan, and pay "as they go," rather than having the negative carry of a long-term fixed-rate borrowing at 4 percent, for example. Combining variable-rate debt with fixed-payer swaps is a way to hedge interest-rate risk when using certain variable-rate products.

A high-quality, diversified variable-rate debt program avoids excessive exposure to any one form of risk, such as those listed in the sidebar above right. Interest-rate risk is a key consideration. Healthcare borrowers should be conservative in how they think about potential variable-rate savings versus fixed-rate debt, because the savings can vary widely. Borrowers should base rate assumptions on longer-term averages of indices.

Examples of Risks to Be Considered With Variable-Rate Debt

Basis or interest rate. Risk resulting from interest-rate variance between yields on assets and costs on liabilities due to different bases, such as LIBOR versus SIFMA or the U.S. prime rate.

Put. Risk that bonds can be "put" back to the hospital by the lender.

Bank. Risk that the bank's underlying credit rating will negatively impact the cost or stability of the loan.

Renewal. Risk that renewal of a bank letter of credit will come at an inopportune time or be unobtainable for a variety of reasons.

Credit. Risk that an organization's credit rating changes while it is using certain programs that are dependent on the organization being at a certain credit level.

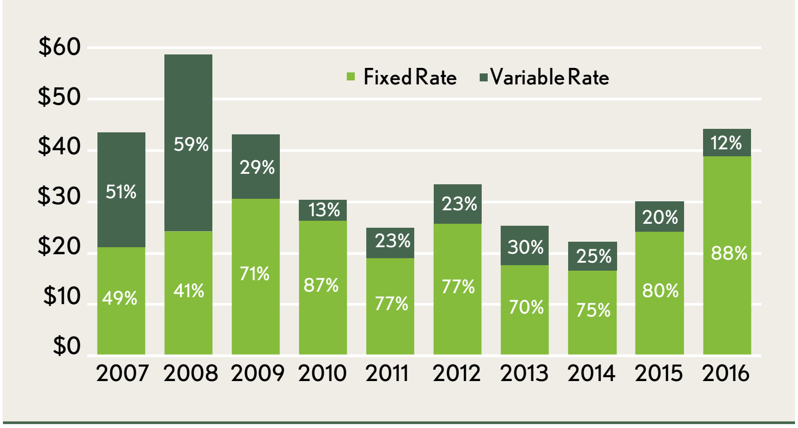
Failed term extension. Risk that the bank or other lender will fail to offer a new term at acceptable rates and/or business terms for a direct loan.

Tax reform. Risk that changes to personal or corporate tax rates, or to the deductibility of tax-exempt interest income lead to a higher cost of funding.

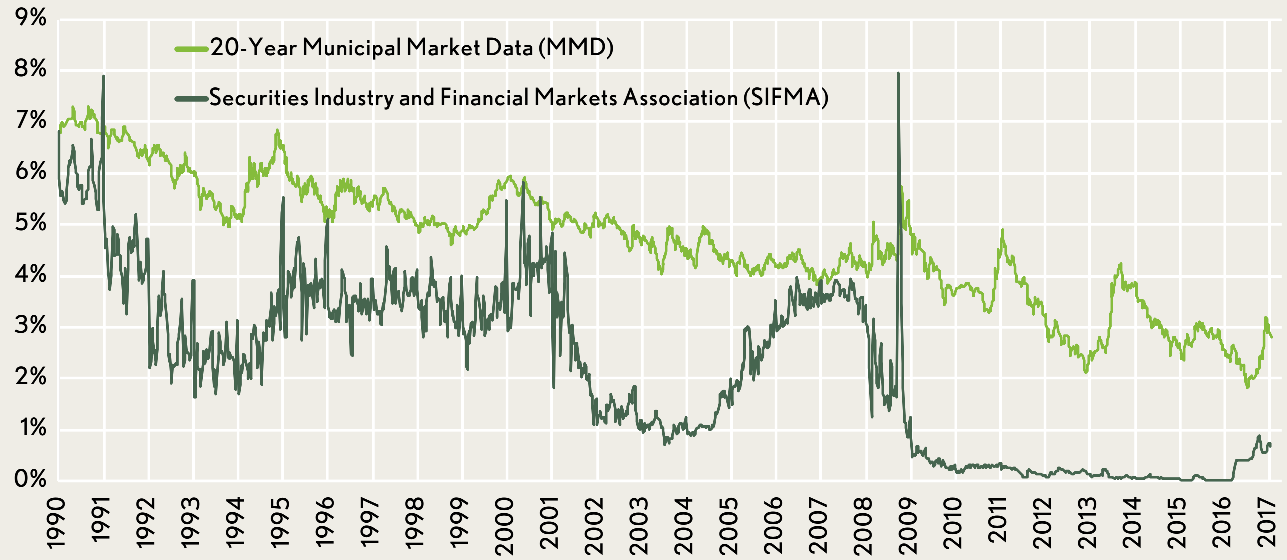
Source: Kaufman, Hall & Associates, LLC

Choosing the correct mix of different variable-rate products is a high-priority task for healthcare finance leaders. A diversified program could include variable-rate demand bonds (VRDBs) backed by a bank facilities or self-liquidity, publicly issued variable index-based securities, bank or other lender loans (e.g., "direct purchase bonds"), and public variable-rate notes. In the

FIXED-RATE ISSUES VS. FLOATING-RATE ISSUES, 2007-16 ($ IN BILLIONS)



TAX-EXEMPT FIXED-RATE (20-YEAR MMD) VERSUS TAX-EXEMPT FLOATING-RATE (SIFMA)



strongest credit cases, a diversified program also could include unenhanced Windows VRDBs.

Each product will have different characteristics that should be considered. For example, with bank variable-rate direct purchases, considerations include operating and business covenants, reporting requirements, frequency of ongoing repayment provisions, yield maintenance and claw-back provisions, grace periods versus hard default, ratings-based pricing for credit spreads, term sheet/commitment expirations, and closing requirements.

Increased use of alternative variable-rate products can be expected as changes occur to interest and tax rates, capital markets dynamics, and healthcare regulatory and payment policies. These factors can compel a rebalancing within and between fixed-rate and variable-rate portfolios.

To fully assess tradeoffs in seeking the lowest cost of capital at an acceptable level of risk, healthcare finance executives should continue to focus on risk and risk relationships in their capital structure decision making. 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 an organization's overall risk.

Use of variable-rate debt and diversification of the variable-rate debt portfolio can help lower overall cost of capital for healthcare organizations. In measured amounts, variable-rate debt issuance can be a winning strategy even when rates remain below long-term averages. Risk assessment and ongoing mitigation strategies are key to successful management of variable-rate programs. ■

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