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market turbulence creates financing opportunity

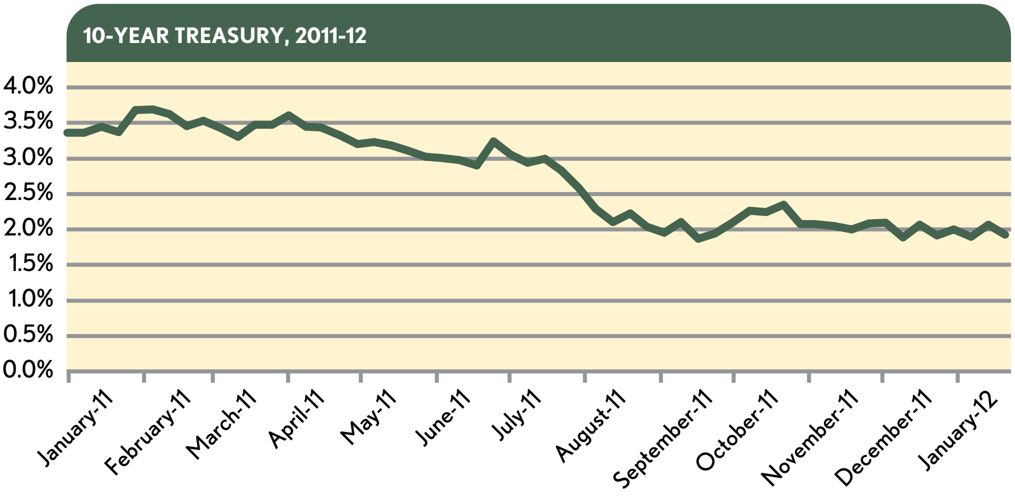
AT A GLANCE

- The flight to high-quality assets resulting from Standard & Poor's downgrade of the U.S. government's credit rating has dropped the yield on U.S. Treasury securities as investors have sought refuge amid uncertain market conditions.
- Consequently, hospitals can now obtain mortgage insurance from the U.S. government to finance expansions and refinance their debt with GNMA securities at taxable interest rates that are often more favorable than tax-exempt bond fixed rates.
- Because GNMA certificates can be sold in a forward purchase transaction that locks in a fixed interest rate while avoiding payment of interest until construction funds are disbursed, they can help avoid the effects of negative arbitrage.

On the evening of Friday, Aug. 5, 2011, Standard & Poor's downgraded the credit rating of U.S. government obligations, citing fiscal policy and debt burden concerns as its primary rationale. Under normal circumstances, one might expect a credit downgrade to result in higher borrowing costs for the U.S. government. Paradoxically, yields on 10-year treasuries, which were 3.22 percent at the beginning of July, dropped to 2.00 percent by September, and have remained in the 2.00 percent or less range ever since.

So why does a downgrade of the world's largest borrower lead to lower treasury rates? Simply stated, U.S. treasuries remain the most highly sought security in the world. Investors continue to value U.S. treasuries as risk-free investments, while sovereign debt concerns among the world's other large economies and concerns regarding the global economy in general have led investors right back to U.S. treasuries in a flight to *relative* quality.

The rapid decline in treasury yields, a global benchmark for many assets, has directly resulted in lower yields in the tax-exempt municipal marketplace. Interestingly, the global demand for treasuries along with uncertainties surrounding the domestic municipal market have essentially eliminated the tax advantages that borrowers have traditionally enjoyed through issuing rated municipal bonds.


10-YEAR TREASURY, 2011-12

The past year has seen a rapid and sustained decline in treasury rates.

Source: Thomson Reuters Municipal Market data.

Financing Opportunity with GNMA Securities

The flight to high-quality assets has dropped the yield on U.S. Treasury securities—and Government National Mortgage Association (GNMA, or Ginnie Mae) securities, which are guaranteed by a promise to pay from the U.S. Treasury—as investors seek refuge amid uncertain market conditions. The recent decline in treasury rates combined with widening credit spreads has created a unique financing opportunity for hospitals that are able to issue highly rated debt. Even lower rated hospitals, for a small fee, can now obtain the same credit ratings as the U.S. government to finance expansions and refinance their debt with GNMA securities at taxable interest rates that are often more favorable than tax-exempt bond fixed rates.

Hospitals obtaining FHA mortgage insurance under Sections 242 of the National Housing Act can use the issuance of GNMA pass-through certificates, or GNMA-backed corporate bonds rated Aaa/AA+/AAA based on the full faith and credit of the U.S. Treasury. Even with the cost of FHA mortgage insurance (50 basis points, or 0.50 percent annually) and the additional servicing and GNMA fees (an additional 25 to 50 basis points), a hospital's interest rate would in many cases still be substantially below rates available in the tax-exempt bond market for borrowers in the nonrated, BBB, and A credit rating categories. GNMA certificates issued for hospital refinancing transactions may be an attractive option for borrowers with a credit rating of AA or lower. Section 223(f) regulations, which would allow pure refinancings, are currently being finalized. In the meantime, hospital borrowers may access these attractive rates through the Section 242 program if their transactions include "new money" construction projects equal to at least 20 percent of the transaction.

GNMA certificates offer a means of avoiding the effects of negative arbitrage.

Avoidance of Negative Arbitrage

Advantages other than the lower nominal rate may also exist. For a project involving lengthy construction, the absence of negative arbitrage can greatly reduce interest costs. In a tax-exempt transaction, all bonds are issued at closing. Bond proceeds for construction are placed in a project escrow account and drawn upon as construction progresses. The bond proceeds held in escrow earn very low yields in the current interest rate environment. However, the borrower must still pay bondholders the full bond interest rate for all sums borrowed. This interest rate differential results in negative arbitrage on the escrowed construction fund that can be quite expensive.

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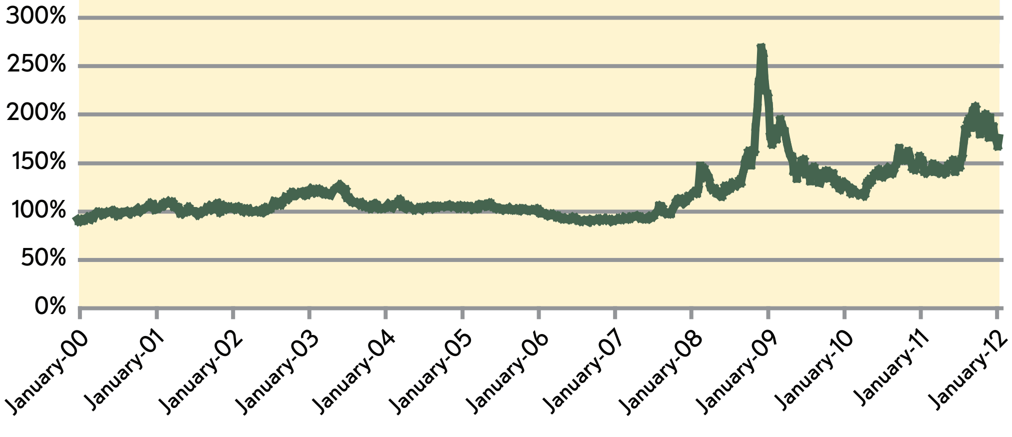
TAX-EXEMPT "A" HEALTHCARE RATES AS A PERCENTAGE OF TREASURIES, 2000-12



Source: Thomson Reuters Municipal Market data.

The credit spreads are widening for lower-rated hospitals.

GNMA rates are substantially less than tax-exempt rates.

APPROXIMATE BORROWING RATES, INCLUDING CREDIT ENHANCEMENT COSTS, IN THE U.S. MARKET AS OF FEBRUARY 2012

FHA GNMA Refinance	AA	A	FHA GNMA New Money	BBB	Nonrated
4.25%	4.85%	5.00%	5.25%	5.65%	> 6.50%

Note: FHA loan maturities are 25 years plus the construction period, if applicable. The interest rate is fixed. AA, A, BBB, and nonrated indicative rates are for 30-year fixed-rate maturities.

RELATIVE EFFECTS OF NEGATIVE ARBITRAGE—GNMA STRUCTURE ELIMINATES NEGATIVE ARBITRAGE

	A	FHA GNMA New Money	BBB	Nonrated
Borrowing rate	5.00%	5.25%	5.65%	> 6.50%
Reinvestment rate	1.00%	NA	1.00%	1.00%
Percentage value of negative arbitrage	4.00%	NA	4.65%	> 5.50%
Approximate negative arbitrage on $100 million construction fund with 12-month average life	$4.00 million	Zero	$4.65 million	> $5.50 million

GNMA certificates offer a means of avoiding the effects of negative arbitrage. The certificates can be sold in a forward purchase transaction that locks in a fixed interest rate while avoiding payment of interest until construction funds are disbursed. The GNMA issuer will enter into a forward purchase contract with one or more prospective investors who agree to purchase the GNMA certificates at a future date as funds are needed. The GNMA certificate for "new money" bears an increased yield to compensate for the forward purchase commitment. Although the yield will be higher than that of a GNMA used for refinancing purposes, the hospital benefits greatly by borrowing monies only as the construction project is funded. This approach typically eliminates millions of dollars in negative arbitrage. The premium in GNMA yield on construction projects over refinance projects will vary depending upon market volatility, anticipated interest rate increases, and the anticipated timing and duration of the construction project.

In addition, the GNMA structure does not require a debt service reserve fund as is common for tax-exempt bonds. Substantial negative arbitrage exists on debt service reserve funds resulting from low investment rates in the current market.

Opportunities from FHA

The FHA hospital program has historically been used by hospitals that would have difficulty accessing AA credit ratings. With GNMA securities at historically low rates, any hospital with outstanding, callable debt should consider accessing the FHA program and GNMA securities. Even highly rated hospitals may take advantage of the FHA and GNMA rates, especially if their projects include substantial refinancing components or lengthy construction periods. ●

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