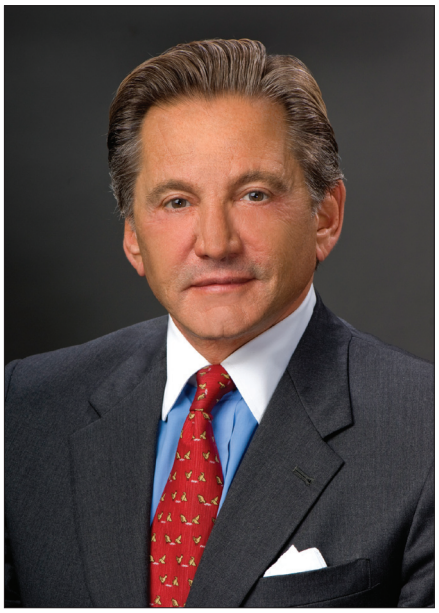
California Healthcare News

cahcnews.com | Articles, Interviews and Statistics for the Healthcare Executive

VOLUME 2, ISSUE 3 MARCH 2010

Build America Bonds Combine with HUD Mortgage Insurance to Provide Exceptional Borrowing Option

By Anthony J. Taddey
Managing Director
Lancaster Pollard



Governmental hospitals seeking capital for renovations, new construction or acquisition may have only until the remainder of the year to take advantage of a temporary Federal option designed to provide lower-interest financing.

At the end of 2010, the ability to designate qualified debt as Build America Bonds (BABs) will sunset if it is not renewed in the federal budget. By designating taxable debt as BABs, borrowers can be reimbursed by the federal government for 35% of their interest coupon expense. Combining BABs with HUD's Section 242 mortgage insurance program creates a lower-cost, long-term, non-recourse debt structure that eliminates the difficulty of finding both a construction and permanent loan.

What are BABs?

Build America Bonds were created by Congress under the American Recovery and Reinvestment Act. Borrowers receive a 35% governmental reimbursement of their interest cost. (Borrowers, including non-governmental entities, in specially designated economic development recovery zones can receive 45% of their interest cost reimbursed by issuing Recovery Zone Bonds. Dozens of California cities and counties qualify.) This reimbursement applies to the interest coupon only, not to any credit enhancement that may be treated as interest in an "all-in" interest cost. BABs can be used by public (government-owned) hospitals to issue debt for new construction, acquisition or other capital expenditures. For 2009, they cannot be used by 501(c)(3) hospitals, by for-profit entities, or for refinancing or working capital needs. President Obama's budget suggests opening BABs up to nonprofits in 2011, but reducing the subsidy to 28%.

Advantages of BABs and HUD Mortgage Insurance

With investor interest concentrated on investment-grade securities, many borrowers are taking a fresh look at HUD's mortgage insurance programs for hospitals. In particular, municipalities are seeking opportunities to finance hospital projects without impacting their debt capacities for other infrastructure needs. Falling tax receipts and uncertainty about future economic development has driven a need for creative financing solutions.

Although interest on paid BABs is taxable income to the investor, the 35% subsidy can often provide a better net interest rate to the borrower than traditional tax-exempt debt. Taxable debt combined with HUD mortgage insurance offers several additional advantages, including:

- Borrowers using federal mortgage insurance with tax-exempt bonds must fund all the bonds at once. This means the hospital is paying interest on the entire issuance as soon as the transaction closes. Taxable bond issuances, however, can be issued on a "draw-down" basis, so bonds are funded as they are needed. BABs insured

with HUD reduce carrying costs by eliminating most of the negative arbitrage normally associated with tax-exempt, HUD-insured construction bonds.

- Hospital borrowers can use BABs insured by the FHA 242 program in combination with GNMA securities to achieve a AAA interest rate. Hospitals cannot use GNMA securities with tax-exempt bonds. To achieve a AA rating with tax-exempt bonds and federal mortgage insurance (not AAA), they must provide for a large debt service reserve fund at closing in addition to providing for funds to cover the 1% of the loan not covered by FHA insurance.

- BABs issued without HUD mortgage insurance can be utilized for an entire issue or in combination with tax-exempt debt. Borrowers maintain the flexibility to designate maturities as BABs or tax-exempt depending on the a) eligibility of the debt and b) the net interest cost of subsidized BABs versus tax-exempt interest rates.

Market Response

The market response to BABs has been very strong. Many bond issuances have been oversubscribed with a wait list of buyers, creating competition that helps reduce interest rates. BABs are expected to comprise more than 20% of the $400 billion annual municipal bond market before the program expires.

BABs have also impacted access to capital for projects not eligible to use them. The popularity of BABs has reduced the amount of tax-exempt bonds available for purchase, as many issuances that would have gone tax-exempt under more normal market conditions chose to issue BABs. As a result, buyers of tax-exempt bonds have fewer investment options even as liquidity returns to the market. For nonprofit hospitals, which do not qualify for BABs, this contraction is helping make traditional tax-exempt interest rates more competitive.

Anthony J. Taddey is a managing director for Lancaster Pollard, a leading provider of debt financing and investment advisory services for hospitals nationwide. Mr. Taddey is the head of the firm's Western Region office in Los Angeles, Calif., and can be reached at (310) 458-9180 or ataddey@lancasterpollard.com. To down-

load Lancaster Pollard's newly-published white paper explaining hospital financing options, visit www.lancasterpollard.com/site.cfm/Our-Focus/Health-Care-Finance.cfm.

BABs Impact on a Hospital's Interest Rate			
	Tax-exempt FHA-242-backed Issue	**GNMA/FHA Sale**	**BABs Issue with GNMA/FHA 242**
Rating Agency Required Deposits	~10%	0%	0%
Cost of Issuance	2%	2%	2%
Total Upfront Costs	**12%**	**2%**	**2%**
GNMA/Bond Coupon	5.75%	6.5%	6.5%
GNMA Guarantee Fee & Servicing	0.1%-0.2%	0.2%-0.3%	0.2%-0.3%
BABs Subsidy	n/a	n/a	(2.275%)
Mortgage Insurance Premium	0.5%	0.5%	0.5%
Net Interest Cost	**~6.4%**	**~7.25%**	**~4.975%**