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Flexible Financing: Taking a Look at Low Short-Term Interest Rates Options

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As an old Chinese proverb says, "Crisis can be used as an opportunity by some." As the U.S. economy continues to struggle, both long-term fixed and short-term variable interest rates have been very low and may remain low through mid-2013, according to the Federal Open Market Committee. Hospitals looking for flexibility in their funding options may want to consider financing a new project or refinance existing debt with a variable-rate financing structure.

Show Me the Interest Savings

The LIBOR one-month rate and SIFMA indices are the taxable and tax-exempt benchmarks for financing debt with short-term rates. The one-month LIBOR rate, currently at .23% at the time of writing this article, is used to price floating-rate notes and variable-rate mortgages. The SIFMA municipal swap index, now at .15%, is used in remarketing tax-exempt variable-rate demand bonds. Both rates have fallen significantly since 2008.

Long-term fixed interest rate financing yields also are low. The recent average general market 30-year A/A health-care bond interest rate is 5.44% and the average Baa/BBB 30-year health-care bond yield is 6.32%. Both are lower than just two years ago.

Both short-term and long-term rates can lower the cost of debt financing compared to just a few years ago. Which is the best way to go?

Using a short-term structure can provide a very low cost of capital and provide future financial flexibility, but it will come with renewal risks. Using long-term fixed rates will lock in today's low rates and provide amortization over a long time, perhaps increasing the amount that can be borrowed. However, these structures provide less flexibility in the first 5 to 10 years. This article will focus on finance structures that use today's short-term rates, which one that works best depends on the type of project needing financing

and how comfortable the borrower is with the terms and inherent risks.

LOC-Backed Variable-Rate Demand Bonds

A LOC-backed variable-rate demand bond provides the borrower access to short-term variable interest rates using a bank's credit rating instead of the borrower's. The interest rate is based on current market levels, often using the SIFMA index. VRDBs have consistently provided the lowest cost of capital and remain attractive in today's interest-rate environment.

Benefits to LOC-Backed VRDBs:

- Cost-effective way to provide credit enhancement.
- Allows ready access to bond market.
- Indices used to set VRDB rates are currently at historically low levels.
- Strong borrowers may be able to obtain a LOC in the 1% range.

The Federal Home Loan Banks LOC Wrap

Federal Home Loan Banks are rated AA+ and can enhance taxable-debt issuances when an FHLB-member bank provides an underlying LOC. This means local banks could provide organizations access to investment-grade credit enhancement usually available only from larger banks.

Benefits to FHLB LOC Wrap:

Provides a higher credit rating and, therefore, lower cost of capital.

- Borrower's LOC fee stays local.
- For larger projects, the borrower can involve multiple local banks so long as the banks are willing to take a parity-security position in the collateral.
- Currently, provides better interest-rate savings than tax-exempt debt plus fewer upfront closing costs and restrictions.

Index Floaters

The index floater is an often overlooked financing structure. Like the LOC wrap, an index floater is most affordable to high noninvestment-grade and investment-grade borrowers. However, this structure also could work for borrowers farther down the credit continuum, including lower-rated and unrated borrowers.

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The index floater is a multi-modal VRDB with an initial index-floater mode or period (typically 3 years) during which the bond pays an interest rate equal to a short-term index plus a fixed credit spread (equal to about what the LOC would have been on a LOC-backed VRDB). The bond can be sold through a public offering or privately placed directly with a bank and is subject to a one-time mandatory tender at the end of the initial period, at which time the bond can be remarketed to any other mode available under the documents. The index floater's interest rate resets periodically (often monthly or quarterly, but could also reset weekly, semiannually or annually).

Benefits to index floaters:

- Avoids LOC and remarketing fees.
- Multimodal flexibility helps keeps interest rates low while providing flexibility after the one-time mandatory tender.

Timing IS Everything

In today's interest rate environment, short-term variable rate financings may reduce the cost of capital when compared to long-term fixed rate structures. If short-term interest rates remain low, the debt-service savings can generate significant cash-flow savings for the organization. An investment banker can help a borrower determine whether financing with today's short- or long-term rates, or a combination of the two, will best meet an organization's circumstances and objectives.

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