

An Option for the Ages: Market Turmoil has put Federal Hospital Mortgage Insurance in the Spotlight. Here's why it Should Stay There

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Much of the recent discussion of federal hospital mortgage insurance has been directed toward smaller facilities that lacked a wide variety of financing options. Rather than being painted as a financing option for a limp economy, however, the Section 242 program should be considered as part of any hospital's financing discussions – under any market conditions. Its competitive fixed interest rates, 25-year amortization

and non-recourse nature make it an excellent choice for small independent hospitals, but also for larger facilities and for systems.

For larger hospitals in particular, FHA 242 may have been off the radar for several decades, especially since the program has only recently become more well-known outside the Northeast, where transactions have historically been concentrated. Started in 1968, the federal hospital mortgage insurance program under the Department of Housing and Urban Development (HUD) has insured over \$15 billion in hospital loans. Transaction sizes range from less than \$1 million to \$756 million. The average loan size of active Section 242 loans is \$81.3 million.

While smaller hospitals may look to hospital mortgage insurance because of its non-risk-based pricing and ability to offer access to investment-grade ratings, larger hospitals can find answers to additional issues within its structure.

Filling the Bond Insurance Void

Since the market downturn, when nearly every AAA bond insurer was downgraded, hospitals have

been left with a void where once they had a reliable source of credit enhancement for fixed- or floating-rate debt.

Federal hospital mortgage insurance, however, fills that void, with amortizations of up to 25 years after construction completion and fixed interest rates. Because FHA programs are not risk-based, the rating on the debt will not change with investor sentiment: FHA 242 insured debt is always the equivalent of at least AA resulting in higher credit ratings than most hospitals currently have or could hope to achieve.

Isolating Riskier Debt

As a non-recourse financing option, hospital mortgage insurance can be used to isolate balance sheet risk by carving out properties from more creditworthy parent corporations or obligated groups. A system with an underperforming facility may choose to finance that property separately to strengthen the balance sheet and potentially expand the system's debt capacity. Should the riskier project run into trouble, the parent system is not liable for the debt.

The combination of the current economic conditions and constant stress about state and federal reimbursements has driven more independent facilities to seek to affiliate or be acquired. As of July 2009, the FHA 242 program can provide financing for acquisitions, spin-offs or refinancing transactions that do not include rehabilitation or new construction. As an acquisition vehicle, a system could acquire a hospital without disrupting the system's credit rating. The system could thereby maintain its debt capacity and credit profile for other capital projects, maintaining ratings on current debt and giving the system flexibility into the future.

The maximum FHA 242 mortgage is 90% of replacement cost. However, the current land value and net book value of property, plant, and equipment is counted toward

the estimated project costs, which can minimize or eliminate the cash equity required. For example, if a hospital with \$50 million in debt wanted to undertake \$20 million in capital improvements and had a current net book value of \$70 million, it could borrow up to \$81 million, or 90% of its replacement cost of \$90 million. In this scenario, the hospital would not have to provide any equity for any project with a mortgage loan less than \$81 million.

Refinancing

Up through June 2009, the Section 242 program could be used to refinance debt only if 20 percent of the mortgage amount was used for new construction projects. This new money requirement made it difficult for some facilities to afford to utilize the program to refinance its debt.

The new money requirement was

eliminated in 2009, and the Section 242/223(f) program was created as a refinance-only option for hospitals of all sizes.

Hospital mortgage insurance has historically been seen as a more cumbersome way of acquiring capital, but significant changes have streamlined the process and removed some of the "big bureaucracy" stigma. A select experienced FHA team including former hospital CEOs, CFOs and private sector healthcare consultants now processes the applications. Processing times have been significantly reduced over the past couple of years, and a new initiative to implement "LEAN" processing, following Toyota's principles of efficiency, is in progress. Additionally, HUD has a "Fast Track" process for hospitals that meet certain financial criteria, which can further com-



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