

**Contents**

**I. Feature:**

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

**II: Senior Living:**

5-Star Ratings and Your Credit Profile

**III: Health Care:**

Warning Signs of a Distressed Hospital

**IV: Affordable Housing:**

Solutions to Affordable Housing Finance Quandaries

**V: The Nonprofit Minute:**

New Accounting Rules Create Greater Accountability for Nonprofits

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**Feature**

*by Anthony J. Taddey*

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

With each passing month, the financial markets continue to recover from the memorable events of fall 2008. For governmental health care and multifamily housing borrowers there remains an opportunity to take advantage of Federal programs designed to unfreeze the capital markets. The key will be whether borrowers are able to act before these resources expire.

The Capital Issue's summer 2009 issue covered the ability to combine local bank financing with Federal Home Loan Bank credit enhancement through December 2010. Also expiring at the end of 2010 is the ability to designate qualified debt as Build America Bonds (BABs). By designating debt as BABs, borrowers can be reimbursed by the federal government for 35% of their interest coupon expense. Combining BABs with HUD's mortgage insurance programs 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. Designating bonds as Build America reduces the cost of borrowing. Borrowers receive a 35% governmental reimbursement of their interest cost simultaneous with their interest payments to investors. Borrowers in specially designated economic development recovery zones can receive 45% of their interest cost reimbursed.

**Build America Bonds can be used:**

- By public/governmentally owned hospitals, affordable housing, and senior housing/care providers.
- For new construction, acquisition and other capital expenditures.

Direct pay BABs cannot be used for refinancing, but debt can be structured to combine a BAB issuance with a separate tax-exempt issuance to meet the refinance need.

If refinancing or funding working capital is an objective, the debt can be split to include issuances of both "direct pay" taxable BABs for capital expenditures, and a traditional tax-exempt bond issuance to cover refinance and working capital needs.

This reimbursement applies to the interest coupon only, not to any credit enhancements that may be treated as interest in an "all-in" interest cost.

BABs can be used by public (government-owned) hospitals, multifamily housing providers, senior housing and care providers, and other public entities to issue debt for new construction, acquisition or other capital expenditures. They cannot be used by 501(c)(3) organizations, by for-profit entities, or for refinancing or working capital needs (If refinancing or funding working capital is an objective, the debt can be split to include issuances of both "direct pay" taxable BABs discussed in this article for capital expenditures, and a traditional tax-exempt bond issuance to cover refinance and working capital needs.)

# The Capital Issue: Feature

## HUD Mortgage Insurance Update

With investor interest concentrated on investment grade securities, many borrowers are taking a fresh look at HUD's mortgage insurance programs for hospitals, senior living and multifamily housing projects. In particular, municipalities are searching for opportunities to finance these types of 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.

### HUD Mortgage Insurance Benefits:

- Fixed interest rate
- Long amortization
- 90% loan-to-Value
- Provides Construction & Permanent Financing
- AA or AAA rating
- Non-Recourse requiring no financial guarantors: HUD provides mortgage insurance solely on the strength of the underlying project. As a result, a sponsoring governmental entity does not need to provide a financial guarantee.

## Further Advantages of BABs and HUD Mortgage Insurance

Although interest on BABs is treated as taxable income, the 35% subsidy can provide governmental borrowers a better net interest rate. In addition, because BAB-designated debt is taxable, there are several additional advantages, including:

- Housing and health care borrowers using federal mortgage insurance with tax-exempt bonds are expected to fund all the bonds at once. This means the borrower is paying interest on the full amount of the issuance as soon as the transaction closes.

It also means the borrower has the opportunity to reinvest those bonds to receive interest payments, but current reinvestment rates are lower than borrowing rates, resulting in negative arbitrage.

Taxable bond issuances, however, are frequently issued on a "draw-down" basis, so bonds are funded as they are needed. Taxable BABs, then, reduce some of the bonds' carrying cost by reducing negative arbitrage, though some up-front deposits may still be required in some situations.

- Hospital borrowers can use taxable 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 (though housing and senior care providers can). To achieve a AA or AAA rating with tax-exempt bonds and federal mortgage insurance, they must provide for a large debt service reserve fund at closing in order to secure an FHA note, in addition to paying a 1% FHA assignment fee on top of the cost of their mortgage insurance. Taxable BABs eliminate the needs for this 1% fee and large reserve deposit.
- BABs 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 potential market for regular direct pay BABs is much broader than the market for tax-exempt bonds, and the response 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 taxable BABs. As a result, buyers of tax-exempt bonds have fewer investment options even as liquidity returns to the market. For nonprofit borrowers of tax-exempt bonds – e.g. nonprofit hospitals or senior living, or religiously affiliated public housing entities, which do not qualify for BABs – this contraction is helping make tax-exempt interest rates more competitive.

### BABs Impact on a Hospital's Interest Rate

Savings would be similar for a senior living or multi-family provider.	Tax-exempt FHA-242-backed issue	GNMA Sale	BABs Issue
Rating Agency Required Deposits	10%	0%	0%
Cost of Issuance	2%	0%	2%
<b>Total Upfront Costs</b>	<b>12%</b>	<b>0%</b>	<b>2%</b>
GNMA/Bond Coupon	5.25%	6.5%	6.75%
BABs Subsidy	n/a	n/a	(2.36%)
<b>Net Interest Cost</b>	<b>5.25%</b>	<b>6.5%</b>	<b>4.39%</b>