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Feature

by Steven W. Kennedy, Jr.

Looking Locally for Lower-cost Credit Enhancement

At a time when many national banks are still loath to lend, borrowers are turning to a recently-created financing option that lets smaller local banks participate in debt structures usually available only from much larger institutions. Non-rated and low-investment grade hospitals, senior housing and care providers and others are leveraging local bank resources to finance projects that might otherwise be put on hold.

Congressional legislation opened up this opportunity in June 2008. It allowed Federal Home Loan Bank (FHLB) letters of credit (LOCs) to be used in conjunction with tax-exempt local bank financing commitments, resulting in a financing solution on par with what can be offered by the country's strongest investment-grade rated banks, and enabling non-rated borrowers to issue bonds with the high FHLB ratings, most of which are AAA.

The change came just before the near-collapse of the capital markets in fall 2008, when larger banks that had more exposure to sub-prime mortgages stopped lending to all but the highest-rated borrowers. Since then, the 12 Federal Home Loan Banks have been working to educate local banks about the LOC option so these smaller community institutions can compete with the national banks on community financing projects.



Swiss Village's Arthur & Gloria Muselman Wellness Pavilion was the first project in the nation to benefit from the new FHLB LOC usage.

**Swiss Village:
Leading the (Local) Way**

Swiss Village, a continuing care retirement community in Berne, Ind., was the first to utilize this structure. Lancaster Pollard financed the new wellness center and renovations to the senior living campus' assisted living facilities through tax-exempt bonds enhanced by a \$7.0 million direct-pay LOC from the Federal Home Loan Bank of Indianapolis. The FHLB LOC is ultimately supported by two local banks, neither of which has an independent credit rating. Wrapping the local banks' LOCs with the Federal Home Loan Bank LOC provided a higher credit rating, and thus a lower interest rate for Swiss Village.

With the financial markets in turmoil, obtaining this level of credit enhancement (which reduces the cost of borrowing) could have been very costly: The large, investment-grade rated banks that typically offer letters of credit were, and are, experiencing

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historic financial challenges.

And because the majority of local banks do not maintain investment-grade ratings, they typically could not provide borrowers this type of credit enhancement unless a larger national bank also participated, which can become expensive and dilute the local bank's involvement in the community project.

Swiss Village's transaction was completed through the Indianapolis Federal Home Loan Bank, which has since completed four other transactions for three other clients, including a packaging company, a hospital, and a food company. A second senior living provider is anticipated to close soon through Lancaster Pollard. Similar numbers of transactions have been completed at other FHLB offices, including several in Atlanta and Boston and at least 10 in FHLB San Francisco, according to Mark Blasinsky, business research and development director for FHLB Pittsburgh, whose office is compiling a national FHLB LOC database.

Spreading the Word

Community banks', borrowers' and underwriters' awareness of the FHLB LOC option has been slowly improving, helped by education sessions put on by the FHLBs. In March, FHLB Indianapolis held a webinar to explain the option to member banks so they in turn could explain it to potential borrowers in their communities. Interest was strong: The webinar sold out, and questions had to be cut off after 45 minutes. Several other FHLBs have also

About the Federal Home Loan Banks

The 12 Federal Home Loan Banks lend and provide services to 8,100 local community banks and credit unions, which own the FHLBs as cooperatives. These local banks must be members of the FHLB system to borrow from the FHLB and to utilize financing options such as LOC wraps. Each of the FHLBs operates independently and has its own credit rating.

As of June 2009, 10 of the 12 FHLBs were rated AAA by S&P. FHLB Chicago was rated AA, and FHLB Seattle was rated AA+ and on a negative watch for a potential downgrade because of exposure to subprime mortgage-backed securities. In May, Moody's reaffirmed its Aaa rating on the entire FHLB system's long-term debt.

held education sessions to introduce the product to member banks.

"Certainly it's generated a lot of interest and enthusiasm. A lot more members are taking a hard look at this as part of their mix of products and services for their banks," Blasinsky said. "For many of our community banks, this is a great opportunity to compete with the national banks as a credit enhancer."

Some of the responsibility for taking advantage of this option, however, still falls to the borrower and its financial advisor or investment banker, as knowledge distributed to bank leaders through webinars may take some time to make it through the system to lending officers working directly with borrowers.

The FHLB LOC wrap is a viable option for small-to-medium-sized projects, but it will be limited by the local banks' capacity to lend. Some smaller banks cannot take on too much exposure to one particular borrower, making loans of over \$15 million or so more difficult for one bank to handle on its own. In the case of a larger project, however, the borrower has the option to involve multiple local banks, so long as the banks are willing to take a parity security position in the collateral. While some banks may be inhibited by market conditions and are holding back on lending to retain liquidity, many other local community banks still have considerable capacity to lend, and are willing to do so.

Congressional permission for the FHLBs to credit-enhance new tax-exempt non-housing bonds expires Dec. 31, 2010, though LOCs put in place before that time will be able to be renewed down the road. Efforts are under way to request permission to continue the product for new enhancements after Dec. 31, 2010.

Despite the yet-to-thaw markets, demand for health care and seniors housing capital remains strong, and providers cannot always wait for optimal market conditions. For more information on involving local banks in financing projects through the FHLB letter of credit option, please contact Lancaster Pollard at (866) 611-6555.