THE BOND BUYER

Commentary

Thursday, March 10, 2016 | as of 2:41 PM ET

Assessing the Less Contemplated Risks of Bank Placement Agreements

Direct bank placements have been increasingly utilized as a capital source for healthcare and other tax-exempt entities over the past several years. While our focus is within healthcare finance, the potential risks discussed here are relevant to entities across the entire municipal landscape. Due to the private nature of bank placements, it is difficult to assess the total size of the market; however, it is not uncommon to find one or several bank placement obligations on a not-for-profit hospital's balance sheet. Borrowers have eagerly taken advantage of the attractive cost of capital, ease and speed of execution, as well as lower issuance cost and less required documentation compared to publicly issued bonds. As many of our clients prefer to use their limited time and resources on running their core business in this disruptive operating environment, bank placement financing has emerged as an appealing capital source.

A number of sources, including the rating agencies, have done a commendable job of educating the marketplace on certain risks associated with bank placements. The emphasis of the bank placement risk discussion has generally been focused on the ability of lenders to accelerate debt repayment, the renewal risk or contingent liability aspect of many agreements, as well as the general lack of public disclosure on key covenants and events of default included in bank agreements.

Tax-exempt bank placements are structured in various forms including variable rate, synthetic fixed rate (variable with an interest rate swap or hedge) and natural fixed rate. The natural fixed rate bank placement has been a popular

structure for many not-for-profit hospitals as an alternative to interest rate swaps. As the bank placement market has evolved, we have noted certain provisions have become more onerous, making the typical natural fixed rate bank placement structure share a risk profile – not dissimilar to interest rate swaps, but in a slightly different and perhaps more adverse form.

In our view, one of the most underappreciated risk elements of bank placements is the "yield maintenance" or "increased cost" provision. This clause allows the lender wide latitude to unilaterally increase the underlying all-in interest rate by modifying the interest rate, tax-exempt ratio or credit spread of the agreement. Typically yield maintenance language in bank placements does not specify what conditions would trigger the bank to raise the underlying placement all-in interest rate, but rather very broadly specifies the considerations allowing yield maintenance enactment for a wide variety of developments.

The current environment in bank lending is trending toward more onerous regulation and greater capital requirements, led by Dodd-Frank and Basel III. These and other regulatory changes could lead banks to enact yield maintenance language to retain bank placement returns on capital. If additional capital requirements are imposed on banks for any reason, including a bank downgrade, additional costs could be passed on from the bank to the borrower. In tax-exempt placements, a tax-law change that reduces the tax-benefit banks generate from tax-exempt lending could lead to an enactment as well. While these are several potential examples, the open-ended nature in which yield maintenance provisions are drafted in documents provide banks extreme leeway in not only the circumstance that can trigger enactment but also the magnitude of the increase or compensation owed to the bank upon enactment. While no bank lenders have enacted these provisions to date and we still view the probability of enactment as low despite the heightened bank regulatory agreement, all borrowers should be fully aware of these provisions at the management and board level and the potential for interest rate increases that could be significant under most bank documents. Further, in recent transactions, we are seeing banks require the ability to retroactively enact yield maintenance provisions up to 12 months from the time they give notice, so in essence the bank could ask for payment of the lost yield up to a year prior to the borrower even receiving notice.

Another consideration for borrowers is the make-whole call provision currently included in many natural fixed rate bank placements. Make-whole calls are fairly standard in the taxable fixed rate bond market, but of course,

nearly every long-dated municipal fixed rate bond is structured with a 10-year par call option. One implication of a make-whole call is it virtually eliminates the ability to economically refund a fixed rate placement. While on shorter bank placements this is not necessarily a major concern for a borrower, it becomes a more important consideration on a longer-term placement of greater than 10-years.

The other important discussion point with make-whole call provisions is the one-way termination structure. Most fixed placement call provisions only include a scenario where the borrower will make a payment to the bank. If interest rates increase and the borrower wanted to refund the debt; the borrower would receive no compensation. However, if interest rates have declined or if the current rate levels are less than the yield or formula in the make-whole call, the borrower would be required to pay a make-whole premium to the bank. While make-whole call provisions vary by bank, some require strict yield maintenance to call the bonds, meaning the make-whole premium would require the payment of the underlying bank cost of funds (which can be a subjective interest rate) plus the entirety of the credit spread. On taxable bond issues, the make-whole call formula is typically based on a formula of Treasury rate plus a spread that is materially less than most bank placement credit spreads, making the bank placement make-whole provisions potentially more punitive in comparison.

As noted, we believe yield maintenance and make-whole call provisions to be important consideration points, but borrowers should also understand and contemplate the relationship between both the yield maintenance and make-whole call provisions. For example, considering if a yield maintenance provision is enacted and how it could ultimately impact any potential make-whole premium if the borrower desires to refund the debt following the yield increase.

One final trend in the current bank placement market is to also include ratings based downgrade triggers as an event of default under the agreement. In addition to covenants that are often stronger than public fixed rate bonds, a ratings downgrade trigger adds another risk element that could potentially allow a bank placement provider to accelerate debt upon an event of default breach. Managing to a rating covenant isn't as controllable as managing to discrete financial covenants; such as days' cash on hand, maximum annual debt service coverage or debt-to-capitalization requirement. We also note, recently, hospital ratings have been adjusted solely based ratings criteria changes.

In summary, we believe that bank placements will continue to be an attractive capital source for not-for-profit hospitals for all the advantages they offer regarding cost of capital and ease of execution. However, as noted, the lower cost of capital does not come without certain inherit risks compared to traditional publicly offered bonds. While no banks have enacted yield maintenance/increased cost provisions in bank placements to date and we see enactment as a low probability event, we believe this is the key systemic risk of the structure and potential high severity. One of the key lessons of the financial crisis is to understand and contemplate all the risks embedded in financing agreements. Ultimately, we believe it is critical for borrowers to contemplate how these risks fit in the overall capital structure and within the organization's risk tolerance.

Mike Quinn is managing director and Todd Smart is a vice president of Ziegler Investment Banking, Healthcare Finance.

© 2016 SourceMedia. All rights reserved.
Mobile Version