Case Studies: Three Hospitals Secure Section 242 Financing Amid Market Meltdown

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In the churning storm of the capital markets, many hospitals find themselves treading water rather than moving forward. The constant progress required to maintain reputations and technologies has, for some, stalled because of the cost of capital.

Yet, the three facilities profiled in this article used federal mortgage insurance to obtain affordable financings for replacement facilities—during the same time period in which bond insurance nearly collapsed, banks increased credit enhancement prices, and investors closed their wallets even to highly rated hospitals.

The cost of this credit enhancement does not fluctuate with the markets, and the non-recourse pricing can be appealing to both independent hospitals that may in the future seek to affiliate, or to large systems that want to create a separate financing structure for related hospitals of any size.

For many hospitals, federal credit enhancement through the Section 242 Program has become the only financing option, and both investment-grade hospital systems and unrated small, rural facilities are turning even more to a resource that has been around since 1968. In the first seven months of this fiscal year, the Federal Housing Administration (FHA) already has seen as many hospitals seeking mortgage insurance as it did in all of FY08. The Section 242 program can finance construction and other projects in any market, but it is particularly valuable in the current one.

Three Hospital Stories

For the three hospitals profiled in the following case studies, using federal mortgage insurance meant saving community resources now and laying the physical groundwork for solid financial futures.

Fall River Hospital: 242 provides 90 percent leverage

The cost of hospital mortgage insurance does not depend on market whims. It is half a percent of the loan amount, regardless of market conditions, and no matter how big or small the hospital. It is also one of the only ways to get a loan for 90 percent of the project's value, a debt amount that can make banks balk in the best market.

Residents in Hot Springs, S.D., near Mt. Rushmore, had access to health care for 91 years at Southern Hills Hospital until the facility closed in 1998. Faced with a lack of healthcare services within 60 miles, the community rallied to save the hospital. With the help of fundraising and designation as a critical access hospital, the facility reopened in 2001—renamed as Fall River Hospital. The old hospital building, though, was literally a castle on a hill with no room to meet the demand for additional services and advanced technology.

Fall River had limited ability to provide equity, and it needed to finance as much of the project as possible. The hospital discussed issuing unenhanced bonds, but pricing was not favorable. A request for a letter of credit to support financing of 90 percent of the project cost received limited interest, despite the hospital's strong financials and a credit profile that would have been received favorably by the private sector in previous months. The market was just starting to tighten, and small hospitals were some of the first to feel the impact.

Fall River's overall financial strength and its ability to provide evidence of community support were key factors in securing Section 242 mortgage insurance. The 242 credit enhancement enabled Fall River to borrow 90 percent of the project's value. A $500,000 Community Development Block Grant and donated land made up the rest of the equity contribution.

As a result, the hospital was able to fully finance its new facility. The commitment to a new building already has helped the hospital recruit several new physicians and clinical staff.

Gooding Memorial Hospital: 242 enables hospital to break ground early

Gooding Memorial Hospital's bond issuance hit the markets in the middle of the liquidity crisis, when highly rated variable-rate bonds were put back to remarketing agents and auction-rate bonds failed. The hospital had completed the underwriting process and received its 242 federal mortgage insurance commitment, and all that was left was to sell the bonds to investors. But the Idaho-based Gooding could not comfortably afford the interest rates that were being offered when its project came to market.

Fortunately, Gooding had requested permission from the U.S. Department of Housing and Urban Development (HUD) for an early start, meaning it was allowed to progress on portions of the construction project before the loan was sold. An early start option means the hospital is building without a permanent loan in place, so careful consideration and planning should be involved because the hospital will be exposed to financial risk for the costs during that time. For Gooding, most of the financial risk was mitigated by achieving favorable construction costs. With Idaho's rough winter imminent, the hospital broke ground so as to lose no time while its investment advisors continued to pursue lower interest rates.

Gooding removed its bond offering from the market in late 2008 to avoid a predatory environment in which the few active investors were demanding high interest rates. Funding in that market could have cost an additional $3 million in interest cost during the first 10 years of the bond issue. Gooding returned to the market in 2009 and was able to secure an interest rate that was affordable within its FHA mortgage insurance underwriting structure.

Carlinville Area Hospital: Getting financing despite the markets

One of the most important elements to Illinois' Carlinville Area Hospital was updating its facility quickly. Falling admissions were attributed to the older plant, and several physicians were near retirement. But renovating the landlocked hospital in phases would have taken four years, so it sought financing to replace it.

Carlinville went to the market for financing at the same time the fallout from the subprime mortgage crisis froze liquidity in the credit markets. With the future of the markets uncertain, but the future of the hospital clearly dire, Carlinville needed to move forward. Requests for bank letter of credit enhancements went unanswered. Carlinville, however, was multi-tracking its financing with HUD insurance as one alternative. When the last bank option fell through, the hospital's investment advisors were already part way through the HUD process and were able to switch financing tracks without losing momentum.

Carlinville did not require a high-leverage loan because of a generous community donor, so traditional credit enhancement, or even unenhanced bonds, would have been an option for the hospital in calmer markets. HUD's nonrisk-based pricing made it possible for the project to get financing despite the markets so Carlinville could move forward quickly with its new construction. With future feasibility and cost-efficiency in mind, Carlinville negotiated a five-year lockout, allowing it to refinance if rates are better then,

even though federal mortgage insurance typically requires 10 years before the loan can be prepaid or refinanced.

HUD mortgage insurance is a construction loan and a permanent loan in one, so borrowing hospitals will never face a situation in which they are stuck paying down a higher-interest, short-term construction loan because they cannot find permanent financing. If the markets are no better after the five year prepayment lockout expires, the hospital can retain its permanent financing through the full 25-year amortization.

The 242 Evolution

FHA has reinstituted an effort to develop a “lean” system to streamline the federal mortgage insurance application and closing processes for hospitals and bring the timing more in line with that of traditional credit enhancements.

To respond to staffing issues, the Office of Insured Health Care Facilities, which has been busy handling both senior living and hospital mortgage insurance processing, has been authorized to add 20 new employees. The fiscal 2010 federal budget may provide for other staff additions.

The possibility of allowing the Section 242 program to be used for pure refinances has also been suggested. As it stands, the program can be used to refinance hospital debt if 20 percent of the funds are used for new projects. Lifting this 20 percent requirement could create the opportunity for hospitals nationwide to refinance out of strict debt covenants, remove riskier hospitals from a system’s balance sheet, or reduce their interest rate by leveraging the lower risk associated with HUD mortgage insurance.

Fall River Health Services

Gooding Memorial Hospital (North Canyon Medical Center)