

## BANK-QUALIFIED TAX-EXEMPT OBLIGATIONS:

### *A Good Alternative For Certain Small Health Care Borrowings*

**Bank-qualified tax-exempt obligations: a better alternative for certain small bond issues.**

A health care institution wants to borrow several million dollars for a new project. It has investigated the possibility of using publicly offered tax-exempt bonds but has been told that it is not sufficiently creditworthy to access the public markets at attractive rates and/or that the costs of issuance and delay involved in a public offering may outweigh the interest rate advantage of tax-exempt debt. A local bank, familiar with the health care institution, is prepared to lend the institution money. However, the conventional loan rates offered by the bank are high. Is there a better alternative? In certain cases, bank-qualified tax-exempt obligations may be the best alternative, allowing an institution to access tax-exempt rates more quickly and with reduced costs of issuance. In effect, this involves a private placement of tax-exempt bonds with a bank — no underwriting fees, no offering document, and substantially reduced costs of issuance.

#### **What are bank-qualified tax-exempt obligations?**

They are tax-exempt obligations that are issued for 501(c)(3) organizations and state and local governments by a “qualified small issuer” and which are formally designated by the issuer as “qualified tax-exempt obligations.” A qualified small issuer is defined, with respect to obligations issued during any calendar year, as any issuer if the reasonably anticipated amount of tax-exempt obligations (with certain exclusions) to be issued during such calendar year does not exceed \$10,000,000. The rules require aggregating the total issuance by certain related issuers.

#### **Why are bank-qualified tax-exempt obligations better than other tax-exempt obligations?**

Banks are generally not interested in purchasing other tax-exempt obligations because banks are not allowed to deduct the “carrying costs” (interest paid on borrowed funds to purchase bonds) of such tax-exempt obligations. In contrast,

#### *Example*

\$2 million bond issue for small Rhode Island skilled nursing facility that used the funds for renovations and a nine-bed addition

#### *Publicly Sold Bonds (actual)*

Par Amount: \$2 million  
 Ave. Interest Rate: 5.36%  
 Term: 20 Years  
 Letter of Credit Fee: .85 basis points (\$199,000 over life of issue)  
 Cost of Issuance: \$90,000  
 Total Cost: \$1,333,127

#### *Bank-Qualified Tax-Exempt Bond*

Par Amount: \$2 million  
 Ave. Interest Rate: 5.16% (20 basis points lower based on historical data)  
 Term: 20 Years  
 Letter of Credit Fee: n.a.  
 Cost of Issuance: \$45,000  
 Total Cost: \$1,283,383

#### *Commercial Loan*

Par Amount: \$2,000,000  
 Ave. Interest Rate: 7.3%  
 Term: 20 years\*  
 Cost of Issuance: \$35,000  
 Total Cost: \$1,815,639

*\*In some circumstances may only be achieved by extension of shorter-term loan*

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banks are allowed to deduct 80% of their carrying costs associated with bank-qualified tax-exempt obligations. As a result, banks are eager to purchase bank-qualified tax-exempt obligations. In other words, the carrying cost treatment of bank-qualified bonds creates a market for tax-exempt bonds (banks) that might not otherwise exist for a particular health care institution. As shown in the example in the side box on the first page, this translates into lower costs for the borrower.

#### Are there qualified small issuers in every jurisdiction?

No. Unfortunately many borrowers of small amounts are not able to benefit from bank-qualified tax-exempt obligations because there are no qualified small issuers in their jurisdiction. In many states there is a single statewide issuer which issues bonds for health care institutions but issues in excess of \$10,000,000 per year. Borrowers in these states are therefore deprived of access to this lower cost alternative. The National Council of Health Facilities Finance Authorities has worked with other organizations to support legislation that would only require a small borrower — not a small issuer. This would allow access to bank-qualified tax-exempt obligations for all small 501(c)(3) borrowers with capital needs of less than \$10,000,000 per year, not just those that happen to have a qualified small issuer in their jurisdiction.

#### How does one determine if there is a qualified small issuer in a state?

State health facilities finance authorities can provide such information.

#### Are pools a satisfactory alternative?

An alternative offered by many issuers to small borrowers is the ability to borrow through a pool, whereby the issuer issues bonds the proceeds of which will be loaned to a number of different borrowers. These pools can be very effective in reducing borrowing costs, but because they are more difficult to structure and there are underwriting fees involved, they are often more costly than private placements. There are other reasons why pools may not be a better alternative. First, pools are not regularly available in all states, particularly in smaller rural ones. Second, there is often a delay involved while the issuer identifies a critical mass of other institutions interested in borrowing from a pool. Third, pools are usually insured or otherwise credit enhanced, and certain borrowers (frequently including health care institutions) may not meet the credit criteria of the credit enhancers.

*A special thanks to Robert Donovan from the Rhode Island Health and Educational Building Corporation for providing the information for the example on the first page from a deal done by them in December 2001.*

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