

It's finally happened. After prolonged lobbying by healthcare institutions and banks, the Dutch Healthcare Authority (NZA) will amend its policy on standards for long-term interest rates. This means a significant difference on the interest paid on long-term loans.

Healthcare institutions get new possibilities for financing Roll-over loans with swaps now a

The combination of a loan with variable interest (roll-over loan) and an Interest Rate Swap (IRS), is now equivalent to a long-term loan. So the long-term interest on the IRS will be subsequently calculated instead of the lower short-term interest rate on the roll-over loan. With almost 3% separating short-term interest (approximately 0.9%) and long-term interest (3.75%), this is a measure with substantial consequences.

How does this construction work? For a roll-over loan the interest is paid based on the three-month or six-month Euribor with a credit or debit mark-up. The interest rate risk on this short-term

until the money is actually needed. In this example, this means in two years' time. The mark-up on this roll-over loan obviously counts towards the final interest rate relative to the notional interest rate.

Advantage 2: Construction is crisis-proof

Banks cannot presently raise their funding based on capital market interest rates but must pay a steep mark-up. They charge on the mark-up in the price of the loan and the size depends greatly on the term of the loan. But the IRS is not subject to liquidity mark-ups or to increased funding costs due to the credit crisis.

interest is then hedged using an interest swap under which a long-term interest rate is paid over the chosen period and the three-month or six-month Euribor is received. The short-term interest-rate streams are cancelled out against each other, leaving the long-term interest-rate and the credit mark-up.



Figure 1: Roll-over loan with IRS (banks I and II are usually one and the same bank in practice)

Three important advantages

Healthcare institutions have three important reasons for opting for such a construction as an alternative to the familiar long-term loan.

Advantage 1: Hedging of future interest-rate risk

Ahead of raising the money, an interest-rate contract can be concluded with a commencement date that lies in the future. This was not possible with unsecured loans. By so doing the future interest-rate risk is covered based on today's capital market interest rate.

Take for example a healthcare institution that needs to finance a new building deliverable two years from now. The institution can fix the interest rate at or below the level used in the business case. This financing, i.e. the roll-over loan, will not be acquired

The IRS and roll-over combination makes it possible to defer agreement of the financing. This pivots on the expectation that the credit crisis will have passed its peak and that liquidity mark-ups will have fallen. The institution may also elect to conclude a long-term IRS of, say, 10 years, in combination with a relatively short roll-over loan. This will hold down the liquidity mark-up for the loan somewhat, in anticipation of better times.

Advantage 3: Interest Rate Swap can yield money

Using Interest Rate Swaps produces attractive benefits in the event of early repayment. Any positive value of the interest rate contract will yield revenues for the institution. This was something that never occurred with an ordinary loan.

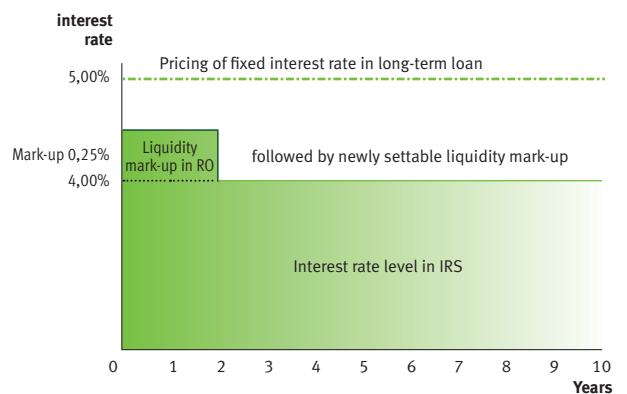


Figure 2: long-term IRS combined with short-term roll-over loan (excluding debtor mark-up)



Allowed in healthcare sector

Excellent construction, but with strings attached

The amended policy will significantly widen possibilities for healthcare institutions to actively manage interest rates according to specific issues that they face, without being punished when the ex-post calculation occurs. This is also essential if they become responsible for the interest rate. So NZa has addressed the consequences of increasing market forces and decreasing ex-post calculation of capital expenses. For that reason alone this decision should be warmly welcomed.

However, healthcare institutions considering a construction of

“The institution can fix the interest rate at or below the level used in the business case.”

this kind need to think about the consequences. They would be well advised to prepare thoroughly before using interest rate derivatives. At various levels within the institution they need to acquire sufficient knowledge of products of this kind. The construction must obviously be formally permissible. The treasury rules must be amended to allow use of the construction. The rules must spell out what is and is not allowed and how decision-making powers are arranged. It is also necessary to conclude a master contract with one or more banks to lay down the rules for interest rate derivatives. A final consideration is the Guarantee Fund for the Healthcare Sector (WfZ), which imposes limits on the use of interest rate derivatives. One of them is the maximum interest rate risk in any year relative to the portfolio of loans.

For these reasons many healthcare institutions will prefer not to get involved in these unknown products. But they need to be aware that financiers will require the covering (at least in part) of future interest rate risks prior to raising the loan. So it is not just the potential financial benefits, but also pure necessity that argues in favour of using interest rate products. Viewed in that light we believe that it is better to adopt an active stance than to wait and be caught by surprise.

Hidden costs

Finally, it needs to be remembered that while IRS is a swap - and in principle no costs are attached to a swap - the actual costs of the IRS lurk in the setting of the level of the long-term interest rate. The bank will raise the capital market interest rate by several

basis points¹. This can mount up over the term of the IRS. Through this mark-up the bank is effectively increasing its debtor mark-up in the financing arrangement. This is because it is usually a condition for the IRS to be concluded with the financing bank. It remains established banking practice not to disclose this IRS mark-up to the client, despite the new arrangements for client/bank relationships as a result of the credit crisis. So it is advisable to agree prior arrangements for this matter. To check fulfilment of the arrangements it is essential to have an insight into current capital market movements plus an efficient computing tool. For this purpose most institutions will enlist the assistance of a treasury adviser. <



▶ IF YOU WANT TO LEARN MORE ABOUT THE BENEFITS OF AN INTEREST RATE SWAP COMBINED WITH A ROLL-OVER LOAN IN THE HEALTHCARE SECTOR OR IF YOU ARE FACED BY OTHER HEALTHCARE-RELATED FINANCING ISSUES THAT YOU WOULD LIKE TO DISCUSS WITH ZANDERS, PHONE ROB VAN HEESCH ON +31 (0)35 692 89 89.

Also read the article about the Sint Franciscus hospital on page 20 of this magazine.

¹ A basis point is 1/100th percent