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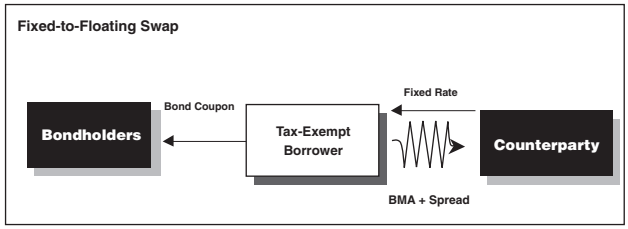
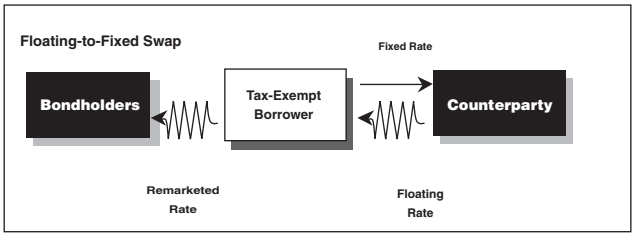
INTEREST RATE SWAPS:
Terms, Advantages and Risks

Healthcare providers (whether not-for-profit or governmental) that may finance capital projects on a federally tax-exempt basis (each a "tax-exempt borrower") have increasingly used interest rate swaps (among other types of asset-based financial derivatives) to achieve their overall financial objectives. These objectives include hedging strategies for "new issue" bonds and the creation of synthetic fixed and variable-rate debt to lower overall borrowing costs while protecting a borrower's financial condition. Interest rate swaps should constitute part of a tax-exempt borrower's comprehensive asset and liability management strategy and not be used for speculative purposes or simply to address short-term financial issues without understanding long-term implications.

This paper is a brief overview of the types of interest rate swaps that tax-exempt borrowers commonly use and the general terms, advantages and risks of those interest rate swaps. For a tax-exempt borrower that is a 501(c)(3) organization, a "conduit issuer" (such as a health facilities financing authority or local government issuer, if authorized by State law) must issue bonds or other obligations the proceeds of which are made available to the borrowers that are governmental in nature, such as county hospitals. While an interest rate swap is based upon the credit and financial obligations of a tax-exempt borrower (whether not-for-profit or governmental), a conduit issuer should also be familiar with interest rate swaps and other financial instruments entered into by tax-exempt borrowers on whose behalf it acts in issuing its tax-exempt bonds.





Fixed-to-Floating Swaps

A "*fixed-to-floating swap*" is a contract between a tax-exempt borrower and a counterparty under which the borrower agrees to pay to the counterparty a floating rate in return for the counterparty's agreement to pay to the borrower a fixed rate. The fixed rate that the counterparty is to pay equals the interest rate on the borrower's underlying fixed rate bond. The floating rate that the borrower is to pay is generally based upon the Bond Market Association ("*BMA*") index, which is a composite index of weekly variable-rate tax-exempt debt, plus a spread or a percentage of the London Interbank Offered Rate (known as"*LIBOR*"), which is a short-term interest rate used in the case of debt obligations that are not tax-exempt. A fixed-to-floating swap may be illustrated as shown:

Floating-to-Fixed Swaps

A "*floating-to-fixed swap*" is a contract between a tax-exempt borrower and a counterparty under which the borrower agrees to pay to the counterparty a fixed rate in return for the counterparty's agreement to pay to the borrower a floating rating. The floating rate that the counterparty is to pay to the borrower equals or approximates the interest rate on the borrower's underlying floating rate bonds. A floating-to-fixed swap may be illustrated as shown:

Net Settlement

The fixed and floating rates payable under a fixed-to-floating swap and a floating-to-fixed swap are netted and the net amount is paid periodically (known as "*net settlement*"). The effect of net settlement is to convert the tax-exempt borrower's interest costs and interest rate exposure from a fixed to a floating rate or from a floating to a fixed rate **so long as** the counterparty performs in accordance with the swap contract.

Tax-Exempt Index or Cost-of-Funds Swaps

Interest rate swaps generally provide for net settlement based upon amounts determined using the BMA index plus a spread or a percentage of LIBOR. A "*tax-exempt index swap*" and a "*costs-of-funds swap*" are each an interest rate swap under which the counterparty's variable interest payments are intended to match the tax-exempt borrower's variable interest payments on the

By: Buzz Larsen

Buzz Larsen is a partner resident in the Chicago Office of the law firm of Chapman and Cutler LLP and has an extensive practice relating to public finance. He has developed a particular expertise over a number of years in tax-exempt lease financing with lease revenue bonds and certificates of participation for equipment acquisition and building construction projects. During the past ten years, Mr. Larsen has acted as investor's counsel or underwriter's counsel for public finance transactions in several States, including financings for healthcare projects. He has acted as counsel in the structuring of a variety of derivative securities relating to public finance transactions.

For More Information
contact: Buzz Larsen 312.845.3473 or
larsen@chapman.com

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underlying tax-exempt bonds. Such swap contracts are not customary, however, and may be costlier than entering into a BMA or LIBOR based swap with "*basic risk*" as described below.

Advantages of Interest Rate Swaps

The advantages of an interest rate swap to a tax-exempt borrower include:

(a) net borrowing costs may be reduced by issuing floating rate bonds and immediately entering into a floating-to-fixed swap rather than simply issuing fixed rate bonds depending upon the counterparty's relative cost-of-funds advantage in its market;

(b) net borrowing costs (including elimination of liquidity and remarketing costs) may be reduced by issuing fixed (rather than variable) rate bonds and entering into a fixed-to-floating swap;

(c) combinations of a tax-exempt borrower's exposure to fixed and floating rates may result in lower overall interest costs over time while being protected in a rising interest rate environment; and

(d) hedging interest rate risk on variable-rate debt through a floating-to-fixed swap.

Risks of Interest Rate Swaps

Interest rate swaps involve risks that have been subject to significant review, analysis and commentary in the recent past, including by the national credit rating agencies, the accounting profession (including the Government Accounting Standards Board) and others who have been concerned about financial management of, and adequate disclosure regarding, these risks. Significant risks associated with interest rate swaps include: (1) "*counterparty credit risk*," which is the risk that the counterparty will fail to perform in accordance with the swap contract thereby exposing the tax-exempt borrower to the costs to replace the counterparty and to any consequences of continuing to perform the borrower's obligations on the underlying bonds without the offsetting benefit of the swap contract; (2) "*basis risk*," which arises as a result of the difference between the basis on which the interest rate on the underlying bonds is calculated and the basis on which the interest rate used for purposes of the interest rate swap is calculated (such as the BMA index or LIBOR); (3) "*termination risk*," which is the risk that the swap contract terminates before its scheduled expiration date as a result of events of default or events of termination; and (4) "*rollover risk*," which is the risk that a tax-exempt borrower with bonds for a term that exceeds the term of the swap contract will be unable to obtain another swap contract at the time that the initial swap contract expires or terminates.

State Law Authorization and Legality

A tax-exempt borrower that is a governmental in nature must, in most States, be expressly authorized under State law to enter into interest rate swaps and other types of asset-based financial derivatives. In addition, such a borrower's obligation to pay net settlement, termination payments or other amounts under an interest rate swap must be structured in light of applicable State constitutional or statutory limitations on the incurrence of "*debt*." Failure to comply with applicable State law requirements may invalidate an interest rate swap entered into by a tax-exempt borrower that is governmental.

Interest Rate Swap Contracts

Interest rate swap contracts have been standardized in a Master Swap Agreement by the International Swaps and Derivatives Association, Inc. Schedules and Confirmations are customarily attached to the Master Swap Agreement to set out the unique terms of a particular swap contract.