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The Latest on LIBOR Phaseout

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In August 2017, Ponder published a paper, "What you need to know before LIBOR disappears", outlining the uncertainties surrounding the eventual discontinuation of LIBOR. Since that paper was published, there have been some important developments related to a LIBOR phase-out.

- SOFR ("Secured Overnight Financing Rate") has been designated by the Alternative Rate Reference Committee (ARRC) as the replacement for LIBOR-based interest rate swaps.

- A survey of market participants conducted by ISDA indicates a preference for cash flow neutral modifications to existing swaps rather than mark-to-market (MTM) neutral modifications. If this method becomes industry standard, Ponder believes it would be detrimental to most hospitals and health systems as it would likely materially lower most swap MTMs.

- Lenders have not yet decided on a replacement index for direct placements and loans, but the development of new benchmarks is underway and SOFR remains a possibility.

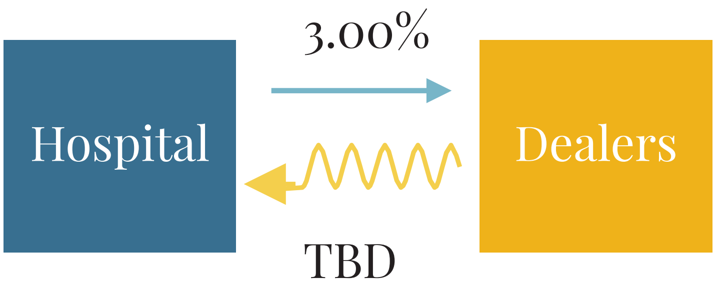
#1 Clarity:
SOFR is Expected to Replace LIBOR for swaps

SOFR is based on overnight repurchase transactions that are secured by US Treasuries. Market participants and regulators are currently working to develop a market in long term SOFR rates, but because the SOFR index has only been published since April 2018, a functional yield curve has not yet been fully developed. A term structure is slowly evolving as 1- and 3-month SOFR futures contracts are gaining market traction and trading volume. At least one dealer has traded long term SOFR swaps; however, these trades have not yet occurred in the tax-exempt market. While a liquid SOFR-based swap market is still in the early stages, we are encouraged by the willingness of banks to foster its growth and maturity.

#2 Uncertainty:
Preferred Method of Swap Modification by Bank Counterparties Creates Risk

The transition from LIBOR to SOFR will require an adjustment to compensate for the difference in the two indices (mostly due to the difference in risk of LIBOR versus SOFR). If there is no adjustment to the receive leg, the adverse effect could be significant for borrowers since, as a secure overnight index, the SOFR rate is expected to be lower than the LIBOR rate. Since most hospitals and health systems receive LIBOR on their swaps, there will be heightened interest in how the adjustments are calculated to make up the difference. There are two main ways to adjust most swaps – cash flow neutral where the cash flow of the swaps would remain the same and MTM neutral where the MTM would remain the same.

Transition to SOFR Example:



Scenario	Receive Formula	Current Annual Cash Flow Impact	Estimated MTM Impact*
No adjustment	67% SOFR	($70,000)	($2 Million)
Cash Flow Neutral	67% SOFR +7bps	$0	($1 Million)
MTM Neutral	67% SOFR +14bps	$70,000	$0

*Hypothetical market conditions assuming $100MM notional with a 20-year life

In 2018, the International Swaps and Derivatives Association ("ISDA") conducted a survey to gather input regarding the development of a LIBOR-to-SOFR transition protocol. The survey sought feedback on how to make the adjustment when the index is changed from LIBOR to SOFR. (Note that this survey was limited to Asian and European participants; however, the same results are expected when the US survey is conducted as many counterparties are the same.) Respondents favored a cash flow neutral approach that would entail making a spread adjustment based on a to-be-defined historical mean or median of the difference between LIBOR and SOFR. This adjustment does not appear to be in the best interest of hospitals and health systems with fixed payer swaps and/or basis swaps that are long term trades. Rather, a MTM neutral adjustment that takes into account the remaining life of the trade will result in no MTM loss, and provide a cash flow benefit in the current market. To avoid this outcome, Ponder is working to develop risk mitigation alternatives that will proactively put not-for-profit entities in a better position before LIBOR actually disappears.

#3 A Bit More Uncertainty:
Variable Rate Debt and Loans that Reference LIBOR

As the market makes the transition away from LIBOR, there is potential for added basis risk if swaps and loans use different replacement indices. While SOFR has been designated to replace LIBOR for interest rate swaps, lenders have not yet decided upon a replacement index for LIBOR. The loan market lacks an association like ISDA, so individual banks are generally able to decide on their preferred replacement index for their loan products under the documents. As an alternative to LIBOR, the Intercontinental Exchange ("ICE") is developing a benchmark index that is intended to serve as a proxy for banks' unsecured cost of funds, much like LIBOR. If successful, the ICE Bank Yield Index could be launched by early 2020. Despite this more "LIBOR-like" index, early indications are that many banks are likely to opt for SOFR due to its acceptance in the swap market and the expectation of continued development as a reliable benchmark; however, no banks that Ponder has surveyed were willing to state a definitive answer on what replacement rate they will use.

CONCLUSION

While much still remains uncertain about the transition away from LIBOR in both the swap and bond markets, a path forward is beginning to slowly take shape. For clients with swaps, there are options to help mitigate the uncertainty of the impending swap transitions which we are ready to discuss. There remains greater uncertainty regarding the future of bonds and loans, and there are currently no immediate steps to take regarding these products. Ponder will continue to provide timely updates on the LIBOR transition as more information is released and there is greater clarity regarding market consensus.