

California Health Facilities Financing Authority
Proposed Adoption of Policy Related to Authority Monitoring of Borrowers

Policy Issue

Staff requests that the Authority adopt a formal policy regarding the ongoing monitoring of borrower's financial operations.

Background

Statutory Requirements

The California Health Facilities Financing Authority was created in 1979 to serve as a conduit financing organization for the issuance of tax-exempt debt for tax-exempt healthcare organizations in California. The California Health Facilities Financing Authority Act (Government Code Section 15430, et.seq., the "Act", see Attachment A) provides for a nine member board vested with all powers reasonably necessary to carry out the powers and responsibilities expressly granted or imposed by the Act.

The statute requires that for purposes of considering applications for financing and project feasibility, the Authority shall establish financial eligibility standards by studying the creditworthiness and earning capacity of each project, together with the amount of pledged revenues, debt service coverage, and basic security. In 2000, the Authority updated and formally adopted its current bond issuance guidelines (Attachment B).

The Act also states that the intent of the Act is to provide financing only, and only to health facilities which can demonstrate the financial feasibility of their projects without regard to the more favorable interest rates anticipated through the issuance of revenue bonds by the Authority. The statute also states that it is not the intent of the Act to authorize the Authority to control or participate in the operation of hospitals, except where default occurs or appears likely to occur.

Because the role of the conduit financing entity is essentially to facilitate the issuance of tax exempt securities on behalf of eligible borrowers and the debt is solely the obligation of the borrower and not the State of California or the Authority, the statute focuses on what the Authority should consider prior to the initial issuance of the securities. As such, the statute is relatively silent on what the Authority should consider after the bonds are issued. Thus, the Authority is empowered to request any information reasonably necessary to carry out its statutory powers and responsibilities of providing financing to health facilities.

Staff requested the Authority's legal counsel to advise staff as to the legal considerations that Authority members and staff should consider when developing a policy with respect to what financial information should be requested of CHFFA borrowers once bonds have been issued and with what frequency. The Authority legal counsel has provided that general guidance (Attachment C), which staff has taken into consideration for purposes

of establishing its policy for Authority approval. Generally, Authority legal counsel recommends that the board consider the following:

- The board members should act reasonably and prudently in determining what financial information should be required, and how often, and should act reasonably and prudently in reviewing and considering the financial information once it is collected.
- In developing a policy, the board members should consider the question of what financial information a prudent person under similar circumstances would require and with what frequency.
- Reasonable prudence dictates that board members should request only such information as the board members need, and are prepared to review and consider, in making decisions on behalf of the Authority (and no more).
- Reasonable prudence and principles of “good government” dictate that CHFFA’s requirements for the submission by borrowers of financial information should be clearly articulated and consistently applied in order to protect against claims of unfair or unequal treatment. If CHFFA’s policy requires more stringent reporting requirements for some borrowers, the policy should clearly articulate the reasons for the different treatment and how those reasons serve an identifiable and legitimate goal of the Authority.
- The board members should act in a manner similar to the way members of other similar financing authorities act.
- In developing a policy, the board members should consider the question of what financial information other financing authorities’ members would request and with what frequency.
- The board members should act in a manner that accomplishes and furthers the purposes of CHFFA as set forth in the Act.
- The board members should clearly know the *purpose and relevance* of the financial information collected at the time of application and the *purpose and relevance* of financial information collected after the loan is made. The purpose and relevance of the financial information should define what CHFFA requires, and the financial information that is collected should assist the board members in meeting CHFFA’s goals.
- In developing a policy, board members should determine what financial information they will need at the time of application in order to determine project feasibility and creditworthiness.
- Keeping in mind that CHFFA has no remedy against a borrower under the standard form of loan agreement in the event of a deterioration in the borrower’s financial condition, the board members should determine what financial information they will need from borrowers after the loan is made in order to meet the purposes for which the information is collected.
- The board members should consider general economic conditions and the needs of the Authority and the State.
- In developing a policy, board members should consider whether the policy will change depending on the current economic conditions and needs of the Authority and of the State, and whether the Authority’s and the State’s economic condition and

needs will affect the Authority's credit policies and the way the Authority views project feasibility and creditworthiness.

What Is Currently Required of Borrowers?

As a condition of consideration for tax exempt bond financing, the Authority currently requires all applicants to complete an application to determine creditworthiness, project readiness, debt service coverage, and loan security. This includes the last 3 years audited financial statements, current year to date interim statements, calculated debt service coverage ratios, utilization statistics and competition, facility governance and a detailed project description. In addition, the organization's management must detail any significant changes or trends in financial data. This project and financial information is required regardless of whether or not the applicant is a prior borrower through the Authority.

For the project, CHFFA requires all sources of funding, a complete description of the entire project, even if CHFFA funds will only cover a portion of the project, current property appraisals, construction permits and contracts, if appropriate, and equipment listing as necessary. If funds will be used for reimbursement, the Authority requires a description of the prior expenditures. For refinancing, CHFFA requires information on the prior debt, a savings analysis or reason for refinancing if not to produce savings and details on the structure of the proposed issue.

While a feasibility study is not required for consideration of the bond issue, CHFFA requests management's projections on revenues and expenses associated with expansion projects or new services to be provided.

Once the application has been submitted to the Authority, it is reviewed and analyzed by both the Authority staff and the Authority Financial Advisor, to determine eligibility, project feasibility and readiness, and that the project meets the Authority's bond issuance guidelines in regards to financial feasibility, minimum debt service coverage ratio, overall creditworthiness and loan security provisions. Should the staff and Authority Financial Advisor agree that the proposed financing meets these criteria, the proposed financing is brought to the Authority at its monthly meeting for consideration.

Should the Authority approve the financing, the standard loan agreement between CHFFA and its borrowers requires that all borrowers must submit annual audited financial statements to the Authority, and if requested, quarterly unaudited financial statements. In addition to annual audited financial statements, each organization must annually submit the following to the Authority:

- A statement showing the net income available for debt service and the debt service coverage ratio
- A certificate from the chief financial officer of the facility stating that no event that constitutes a default of the loan agreement has occurred

- A certificate of the corporation stating that no facility financed with the proceeds of the bond issue will be used primarily for activities of religious worship or sectarian instruction and that the corporation does not restrict admission of patients to the facilities on racial or religious grounds.

In the early 1980's, the Authority determined that it would be fiscally prudent to hire a financial advisor with significant audit experience of nonprofit health facilities to assist staff in analyzing the creditworthiness of potential borrowers and financing structures. In addition to assisting staff in reviewing proposed financings, the Authority Financial Advisor has also assisted staff in monitoring the financial condition of existing borrowers. From the Authority's inception in 1979 to the early 1990's, the Authority staff and the Financial Advisor reviewed the submitted audited financial statements and presented those findings to the Authority. However, at the Authority's request, those annual presentations to the Authority were discontinued, although Authority staff and the Financial Advisor continued to annually monitor the audited financial statements of all borrowers. Under the current Treasurer, the annual presentations resumed in 2000.

The Current Financial Monitoring of Borrowers

The Authority staff, primarily through its Financial Advisor, has developed a review process that has focused on the review of annually submitted audited financial statements of the Authority's borrowers. The Authority staff, with the assistance of the Financial Advisor, reviews the annual financial statements and identifies borrowers who are experiencing financial difficulties and are in danger of violating one or more of the financial covenants included in the bond documents, including debt service coverage ratios or other bond covenant ratios.

Over the years, this process has served to keep the Authority staff abreast of the overall financial condition of its borrowers. When the review process has identified borrowers that are experiencing financial difficulties, Authority staff and the Authority's Financial Advisor have met with these borrowers and discussed the financial position of the institution and its plans for remedying its financial difficulties. While Authority staff have been careful not to intercede in the operations of the borrower, staff have often been able to help advise borrowers as to actions which may be beneficial to the borrower in improving the economic results of the institution. In addition, the annual presentations by the Financial Advisor to the Authority regarding this overall review process has kept Authority members apprised of the general financial wherewithal of the borrowers through the Authority. As such, this Authority has never experienced a default to its bondholders since inception.

In addition, over the last year at the request of the Authority, staff has provided analysis of quarterly financial information of certain borrowers, presentations by the rating agencies, hospital association, providers and individual borrowers (such as Catholic Healthcare West) on the status of their operations and financial condition.

Proposed Policy for Ongoing Financial Monitoring of Authority Borrowers

The Authority has never adopted a formal policy regarding what staff should request of borrowers once bonds have been issued. The financial strains that the non-profit hospital industry experienced as a result of the 1997 Balanced Budget Act and the more recent general economic downturn affecting the investment portfolios of borrowers has generated discussion between staff and the Authority in regards to the appropriate level and frequency of ongoing financial monitoring of borrowers. Specifically, the Authority requested staff to bring a financial monitoring policy, including what will be required and how often, for Authority consideration and adoption.

Considerations Prior to Formulating Authority Policy

In developing a policy for financial monitoring of Authority borrowers, the staff requested the Authority legal counsel and the Authority Financial Advisor to provide guidance as to the respective legal and financial considerations that staff should consider.

In addition, staff asked the two other statewide conduit issuers of tax-exempt healthcare debt, the California Statewide Community Development Authority (CSCDA) and the Association of Bay Area Governments (ABAG), as to their policies regarding ongoing financial monitoring of borrowers. Staff also contacted the state conduit issuers of tax-exempt healthcare debt in other states, including Michigan, Wisconsin, Missouri, Washington and Idaho as to what their policies were and how they handled the information that they received.

ABAG requires submission of annual audited financial statements but does not provide any analysis to its board, nor does it perform an internal analysis of these statements on an annual basis. CSCDA, the state's largest issuer of tax exempt healthcare debt, does not require submission of annual audited financial statements once bonds have been issued and performs no internal monitoring of borrowers.

Responses varied widely amongst the health conduit issuers in other states, ranging from no collection of annual audited financial statements to, in one instance, complete reporting of annual budgets and quarterly operating information. The following summarizes the comments received from each Authority:

Michigan State Hospital Finance Authority

The Authority collects both annual audited financial statements and quarterly statements from all borrowers. However, staff performs no internal analysis and the Authority simply mails out copies of the statements received to a list of interested parties which includes Authority Members and all borrowers. The Authority indicated that the competing hospitals are the ones most interested in receiving the statements.

Missouri Health and Educational Facilities Authority

The Missouri Authority requires borrowers to submit only annual audited financial statements that are sent not to the Authority but to the Trustee. The Authority does not receive copies and therefore does not perform any type of ongoing review of borrowers once bonds have been issued. Trustees ensure that reports are filed with appropriate repositories (the NRMSIRS), but do not respond to requests from the public. This Authority's policy was based upon their belief that while receipt of annual statements was prudent, any analysis and presentation of that information to the Authority at a public meeting could cause liability issues for the Authority.

Washington Health Care Facilities Authority

The Authority receives annual financials and associated certificates of compliance but does not review, analyze or report to its board on any financial statements.

Idaho Health Facilities Authority

The Idaho Authority was contacted because they maintain a very complete reporting system for their hospitals and are closely involved in the actual operations of the state's hospitals. It should be noted that Idaho is by law the sole issuer for health care bonds in the State and as such is the key player in all hospital financings, unlike California. In addition, the state of Idaho has 43 hospitals in total.

The Authority has established a computerized spreadsheet for mandatory reporting by hospitals of all financial and operational data. Annual audited statements are due 120 days after fiscal year end. Capital and operating budgets are due prior to the start of the new fiscal year. Quarterly statements, including detailed investment data shown at both cost and market value are also required. The spreadsheet format calculates all required ratios and other reports, which are sent to all Authority Members. All of this information is reported to the Authority members on a quarterly basis.

The Authority meets regularly with various borrowers to discuss the results of the financial reports and identify reasons for negative performance. In addition, Idaho's loan documents provide the Authority with the ability to require changes in management or operations to meet bond covenants, similar to the authority of California's Cal-Mortgage Program.

Quarterly Unaudited Statements

Staff considered the proposal to require quarterly unaudited information of its largest borrowers. Staff believes that while the Authority should continue to reserve the right to request quarterly unaudited financial statements, we believe that requests for quarterly unaudited financial statements should be done only in extraordinary circumstances that require this enhanced level of monitoring.

We have found a number of difficulties regarding quarterly statements. As the information is provided from quarterly or monthly financial reporting information, the information is not audited and in many cases appears to be unreliable on the surface. In addition, many organizations compile their monthly or quarterly financial information in a manner dissimilar to the format used in the annual audited financial statements and, accordingly, comparisons of the interim information to the annual financial statements is difficult or impossible. With respect to investment portfolio information, Authority borrowers use a variety of reporting techniques to capture realized versus unrealized gains and losses, operating investment results versus non operating investment results, gains and losses from unrestricted investments versus gains and losses from temporarily or permanently restricted investments, and other unique reporting techniques. As a result, it has been difficult, if not impossible, to generate much meaningful financial information from the interim financial data that has been provided at the request of the Authority.

In addition, CHFFA's largest borrowers are all large, rated health systems, with the majority of the debt insured. Staff believes that while monitoring of these systems is necessary and prudent, that these institutions hold the least likelihood of default within the short time period that would necessitate quarterly unaudited statements that have limited meaningful financial information.

Staff Recommendation

Staff believes that, while there is no legal requirement, either in the Authority's Act or in federal tax law, for a conduit issuer to monitor the financial performance of borrowers subsequent to the initial issuance of bonds, this Authority would benefit by maintaining surveillance of the borrowers while bonds issued by the Authority remain outstanding.

Most of the bonds issued by the Authority are either insured or supported by Letters of Credit, which provide additional protection to bondholders for full payment of principal and interest. However, the borrowing health facility pledges to make required payments per the Loan Agreement and some form of monitoring by the Authority of the financial ability of the borrower to continue paying its obligations is prudent. Any potential loan default, even though secured by credit enhancement, could hurt future CHFFA bond issues at the time of initial sale and trading in the secondary market.

Throughout the tax-exempt healthcare industry, audited financial statements are the one standard used consistently for the surveillance of borrower's continuous ability to repay debt. Receipt of audited financial statements provides a comprehensive report in a format that can be analyzed for current year performance and compared to historical reports to determine indications of particular trends. Utilizing audited statements provides other benefits as well:

- Notes to financial statements prepared by the auditor assist the reviewer with obtaining a complete understanding of the operations and financial position of the borrower

- Statements include all adjustments and accruals that may not be made until fiscal year end
- Statements are the only financial reports prepared by outside auditors rather than management of the healthcare corporation
- Statements are required for all borrowers that issue tax-exempt debt; receipt and review by the Authority would be consistent among borrowers and eliminate any claims of unequal treatment
- Investors know that the Authority receives these statements on all borrowers with bonds outstanding and can obtain copies upon request, which has been particularly useful in secondary market trades
- Statements are required to be in standard formats, unlike interim statements, and allow summary reporting on like data to the Authority

Taking into consideration the various experts that provided guidance to the staff in formulating this policy, staff recommends that the Authority adopt the following policy of financial monitoring for all borrowers with outstanding bonds:

1. The Authority staff shall monitor the receipt of annual audited financial statements and review for required loan covenants, including debt service coverage, additional debt tests and certificates of compliance.
2. All annual audited financial statements will be forwarded to the Authority's Financial Advisor for detailed review and analysis. These findings will be presented annually to the Authority.
3. The staff will inform the Authority members immediately, (i.e. not wait for the annual report) in the event any significant negative action occurs on the part of the borrower (such as a missed payment or declaration of bankruptcy).
4. The Authority staff shall continue to reserve the right to request quarterly financial statements in the standard loan agreement. However, staff recommends that it be the policy of the Authority to request quarterly financial information only in the event of an extraordinary event, that in the opinion of the staff, threatens the ability of the borrower to repay its Authority debt, and only through such time that the ability to repay Authority debt is threatened.

Staff believes this proposed policy maintains the Authority member's fiduciary and legal responsibilities and provides the appropriate level of oversight of its borrowers.

Staff respectfully requests that the Authority adopt this proposed policy.