

# Interest Rate Hedging For Healthcare Professionals



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The Healthcare sector is becoming increasingly active in its use of financial services with a common theme being the need for longer-term finance, driven by improvements and investment in infrastructure and services.

While taking advantage of longer-term finance places the healthcare operation on a firm financial foundation, it can also expose it to risk in terms of the uncertainty surrounding future interest rates. An added complexity for the healthcare operator is the long-term impact that changes in the Retail Price Index can have on their operation with income streams from either rent or patients/residents linked to this index.

We believe that interest rate management is an important element in longer-term financial planning. In this booklet we describe what we consider are some of the most commonly used interest rate hedging products currently used in the healthcare field.

The purpose here is not to attempt to provide potential solutions to specific interest rate management issues, rather it is to explain the building blocks of many of the interest rate management solutions used today.

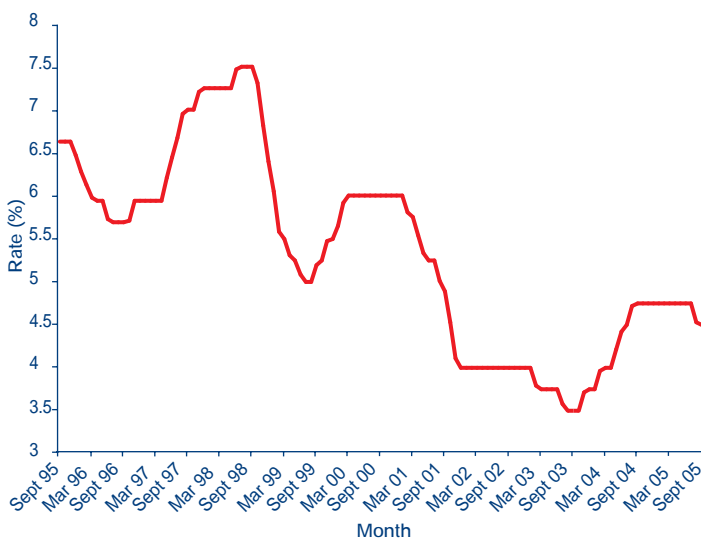
Interest rate hedging solutions are adapted to satisfy a client's individual needs, however at their core are a number of common building blocks such as caps, floors, collars and swaps which form the subject matter here.

By understanding the basics of these products, their application to real life situations becomes clearer.

# Introduction

## Why Consider Interest Rate Hedging?

### UK Base Lending Rate September 1995 to September 2005



Taking a longer-term view shows us that interest rates historically have been volatile, ultimately impacting on the borrowing costs and cash flow of healthcare operators. For many, it is the uncertainty of future interest rate movements that they wish to avoid and the knock-on effect that this could have on their borrowing costs.

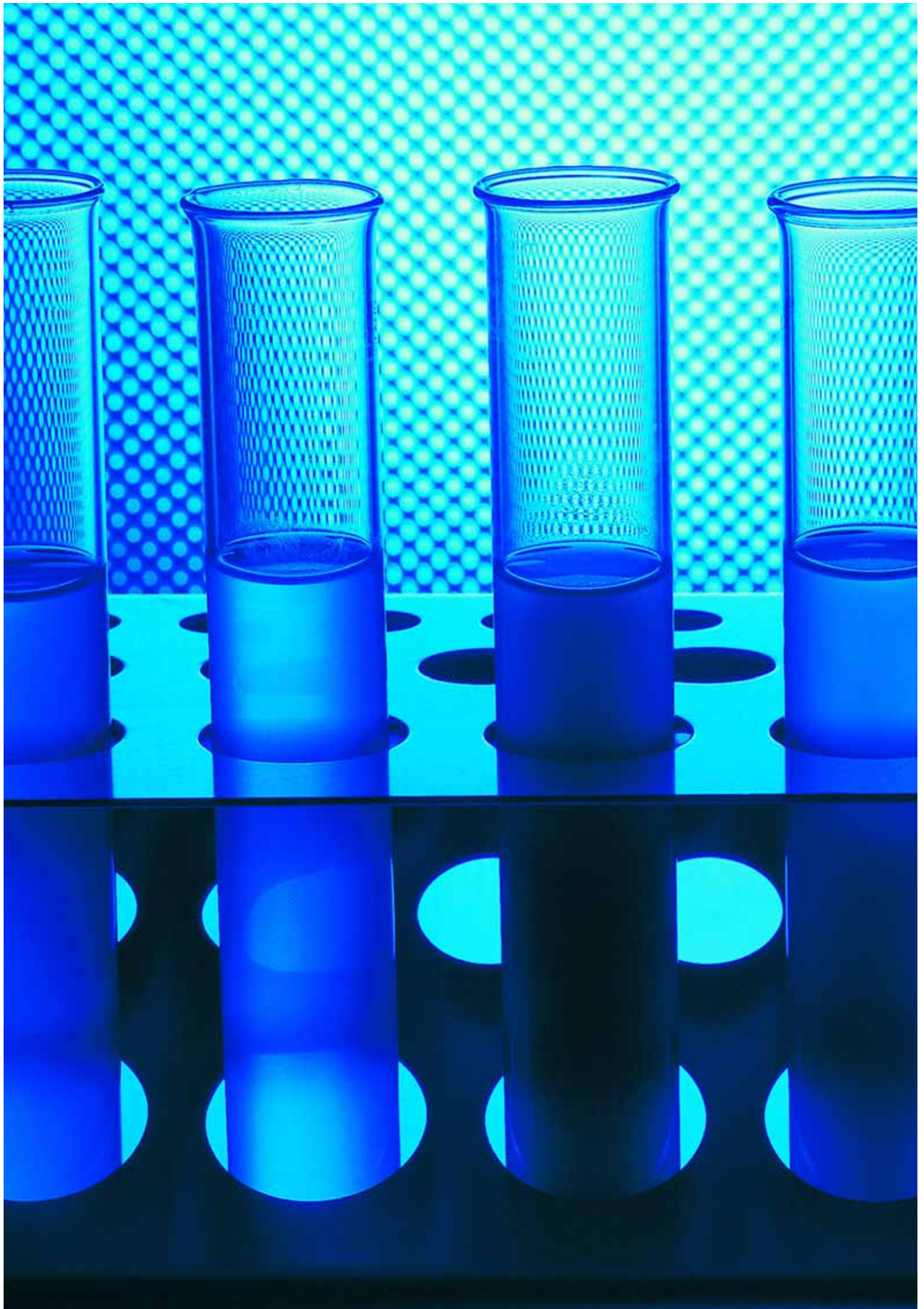
Increasingly, borrowers in the healthcare field are adopting formal interest rate hedging policies which form part of their key financial controls. These policies state how the interest rate risk on borrowing should be managed and what potential solutions should be considered. This then drives the decision to hedge.

For other borrowers without formal policies, it comes down to a need for greater certainty in cash flow planning and budgeting and the need to protect against a critical level of rates where the viability of a healthcare project becomes marginal.

In all circumstances, the importance of considering a range of hedging alternatives should be stressed as no single approach will suit all cases. The individual mechanics of, for example, a residential care home's cash flow will be quite different from that of a health centre or medical practice, making some solutions potentially attractive to one but not the other. The key is to consider a range of alternatives and make a decision based on individual requirements.

In this booklet, the building blocks of the potential solutions are explained, hopefully assisting your hedging decision.

All rates in the following examples are for illustration purposes only and may not be currently available.



# Base Rate cap

A Base Rate cap sets a ceiling on a borrower's interest rate costs. A cap takes the form of an agreement under which the Bank agrees to pay you the difference between the average Base Rate and the strike rate, where the average Base Rate is above the strike rate. Any payments due to you take place at preset times over the life of the cap. In return you pay the Bank an upfront premium.

## Example

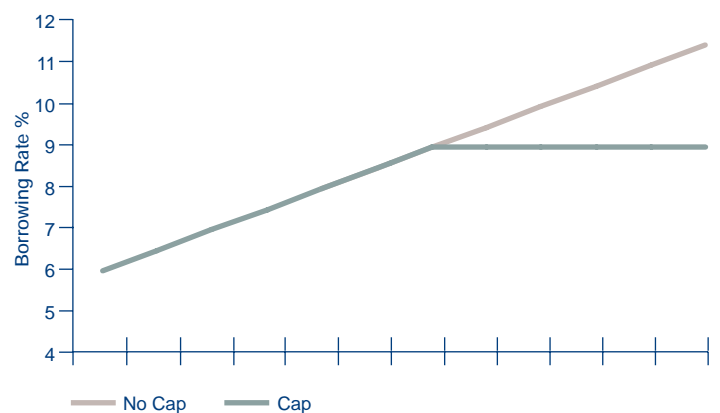
A residential care home has a £1 million 15 year borrowing facility with an agreed loan margin of 2.00% over Base Rate. (Assume the current Base Rate is 4.50%.)

The care home owner wants interest rate protection for 10 years of the 15 year term but does not wish to 'lock in' to a fixed rate, given their view that short-term rates will decline. They decide that interest costs above 9.00% would be difficult to sustain.

The care home owner draws down the £1 million loan and simultaneously buys a 10 year Base Rate cap with a strike rate of 7.00% vs 3 month average Base Rate. (N.B. The loan margin of 2.00% needs to be taken into account when selecting the appropriate strike rate – 7.00% Base Rate + 2.00% margin = 9.00% maximum rate to the customer.) There is a premium payable for this type of protection, which can be paid upfront or in instalments over the life of the hedge.

The effect of the cap on the care home's borrowing cost over the 10 year period is shown below, assuming interest rates steadily rise :

Base Rate Cap Profile



Please note that the above is for illustrative purposes only.



### The Benefits:

- **Independent from underlying loan.** A Base Rate cap is not a commitment to borrow. Therefore a separate decision can be made as to how and where to borrow, and how to manage interest rate exposure.
- **Interest rate protection.** Most commonly, the buyer of a Base Rate cap is seeking to limit the risk associated with rising rates, while retaining the full benefit of declining interest rates. Unlike some other hedging products, the purchase of a cap does not 'lock in' the borrower to a fixed rate, and so if interest rates decline the benefits of cheaper funding are received.
- **Very flexible.** Base Rate caps can be adapted to provide the exact level of protection required. The cap can be for a constant borrowing amount throughout its life or structured on a reducing or increasing amount. Likewise the strike rate can 'step up' or 'step down' to suit specific cash flow forecasts.
- **No credit line.** If the premium is paid upfront, the seller of the cap has no credit exposure to the buyer, meaning that hedging can be implemented speedily.

# Base Rate collar

A Base Rate collar is a combination of an interest rate cap (maximum interest rate) and an interest rate floor (minimum interest rate) and is used to obtain protection from adverse interest rate movements. The borrower is able to benefit from favourable rate movements within a pre-agreed range. The inclusion of the interest rate floor makes the premium for a Base Rate collar lower than that for a comparable Base Rate cap. In fact, a 'zero premium' collar can often be structured so that no premium payment is required.

## Example

A health centre property owner undertaking a purchase and major refurbishment of premises has a £2 million 15 year bank facility with an agreed loan margin of 2.00% over Base Rate. (Assume the current Base Rate is 4.50%.)

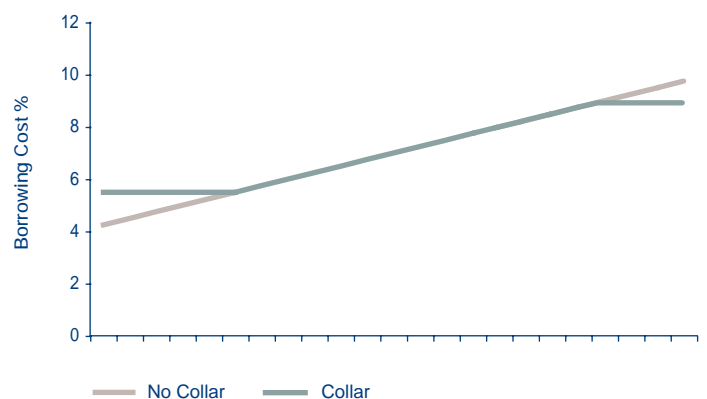
The customer wants interest rate protection for 10 years but does not wish to 'lock in' to a fixed rate, as they believe that short-term rates will decline to a rate somewhere above 3.50%. They have decided that interest costs above 9.00% would be difficult to sustain and do not wish to pay an upfront premium for interest rate hedging.

The health centre owner draws down the £2 million loan and simultaneously purchases a £2 million 5 year Base Rate collar. This involves the purchase of a Base Rate cap with a strike rate of 7.00% vs 3 month Average Base Rate and selling a Base Rate floor with a strike rate of 3.50% vs 3 month Average Base Rate. (N.B. The loan margin of 2.00% needs to be taken into

account when selecting the appropriate cap strike rate – 7.00% Base Rate + 2.00% margin = 9.00% maximum rate to the customer.) There is no upfront premium payable.

The pay-off profile would be as follows:

Base Rate Collar Profile



Please note that the above is for illustrative purposes only.



### The Benefits:

- **Independent from underlying loan.** A Base Rate collar is not a commitment to borrow. Therefore a separate decision can be made as to how and where to borrow, and how to manage interest rate exposure.
- **Certainty.** If the reference rate moves above the cap strike rate, compensating payments will be made to the customer, thereby allowing maximum borrowing costs to be quantified. This allows the customer to produce more accurate budgets and cash flow forecasts. Unlike some other hedging solutions, the purchase of a collar does not 'lock in' the borrower to a fixed rate, and so the benefits of lower interest rates can be obtained. N.B. The floor sets a limit on the level of benefit received if the reference rate falls below the floor strike rate because compensating payments will be made by the customer.
- **Very flexible.** Base Rate collars can be tailored to provide the exact level of protection required. The collar can be for a constant notional amount throughout the life of the transaction or structured on a reducing or increasing notional amount. Likewise the strike rates on either/both the cap and floor can 'step up' or 'step down' to suit specific cash flow requirements.
- **Low up-front premium.** The cost of hedging can be reduced significantly which improves the negative impact on cash flow.

### Potential breakage costs

Additional costs may be incurred in the event that the customer wishes to come out of this arrangement, based on prevailing market conditions, such as interest rates and market expectations of future interest rate changes. This could be the case where, for example, the underlying borrowing is repaid early or re-scheduled. We will be pleased to explain further and provide examples of potential costs.

# Base Rate swap

Base Rate swaps are used by borrowers to manage their interest rate exposures. The product provides a means of converting floating rate debt to fixed rate debt and vice versa. For the two parties involved, it is a contractual agreement whereby they exchange a series of payments based on different interest rate indices, but on a common notional principal. There is no exchange of principal, only an exchange of interest payments.

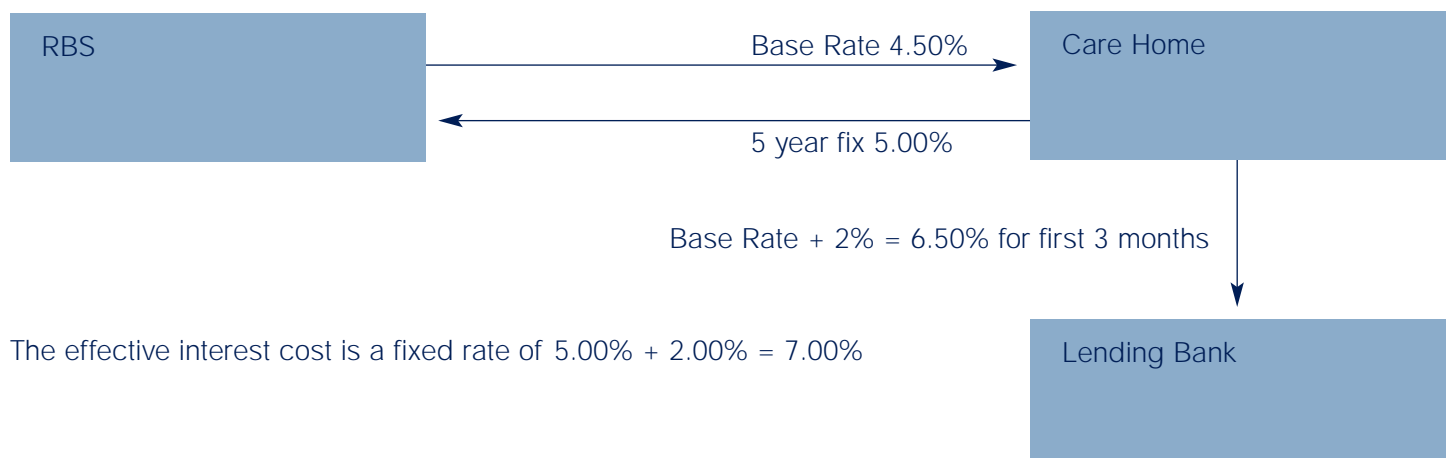
## Example

A care home operator has a £1 million 15 year bank loan with an agreed loan margin of 2.00% over Base Rate. (Assume the current Base Rate is 4.50%.)

The customer wishes to fix their interest cost for a 5 year term as they believe that rates will rise over this period.

They draw down the £1 million bank loan and simultaneously enter into an interest rate swap. The current 5 year swap rate is 5.00%.

Interest flows will be as follows:



The effective interest cost is a fixed rate of  $5.00\% + 2.00\% = 7.00\%$



### The Benefits:

- ***Independent from underlying loan.*** A Base Rate swap is not a commitment to borrow. Therefore a separate decision can be made as to how and where to borrow, and how to manage interest rate exposure.
- ***No up-front fee is payable.*** Unlike some other forms of interest rate protection (e.g. interest rate caps), there is no fee payable.
- ***Very flexible.*** Interest rate swaps can be tailored to suit the borrower's specific hedging requirements and debt repayment profile.
- ***Can be reversed at a future date.*** An interest rate swap can be unwound at the prevailing market rates to reflect changes either to the hedging strategy or underlying borrowing structure. Although this might result in either a cost or a benefit, a customer can, nevertheless, switch from floating rate to fixed rate debt and back again, depending on their views on future interest rate movements.

### Potential breakage costs

Additional costs may be incurred in the event that the customer wishes to come out of this arrangement, based on prevailing market conditions, such as interest rates and market expectations of future interest rate changes. This could be the case where, for example, the underlying borrowing is repaid early or re-scheduled. We will be pleased to explain further and provide examples of potential costs.

# Inflation hedging

A growing number of borrowers in the healthcare sector are now seeking ways to gain protection against the uncertainty of future movements in the Retail Price Index (RPI), the universally accepted measure of price inflation in the UK.

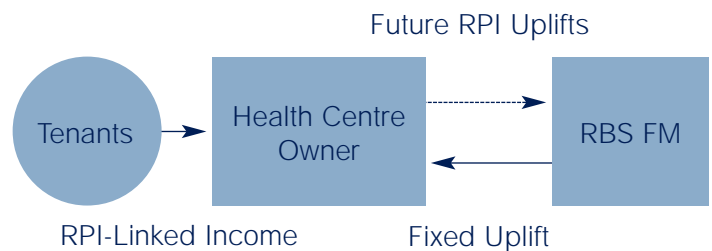
Many of these customers have entered into longer-term projects where the income stream from either rentals or residents' payments are linked to movements in RPI. The majority of these projects also involve longer-term property finance.

For example, some investment property developers with public sector tenants from the healthcare sector have an obligation to have rental reviews based on RPI movements. Given that movements in RPI are uncertain, leading to unknown variable income, this can have an affect on the amount of funding available where a key element of the lender's decision making process centres around the stability of income streams.

Inflation hedging is a method of addressing this issue, meaning that a borrower can take the uncertainty out of lending propositions where future rental income is linked to RPI. This can improve the strength of the customer's borrowing proposition, potentially increasing the amount that would otherwise be available to borrow.

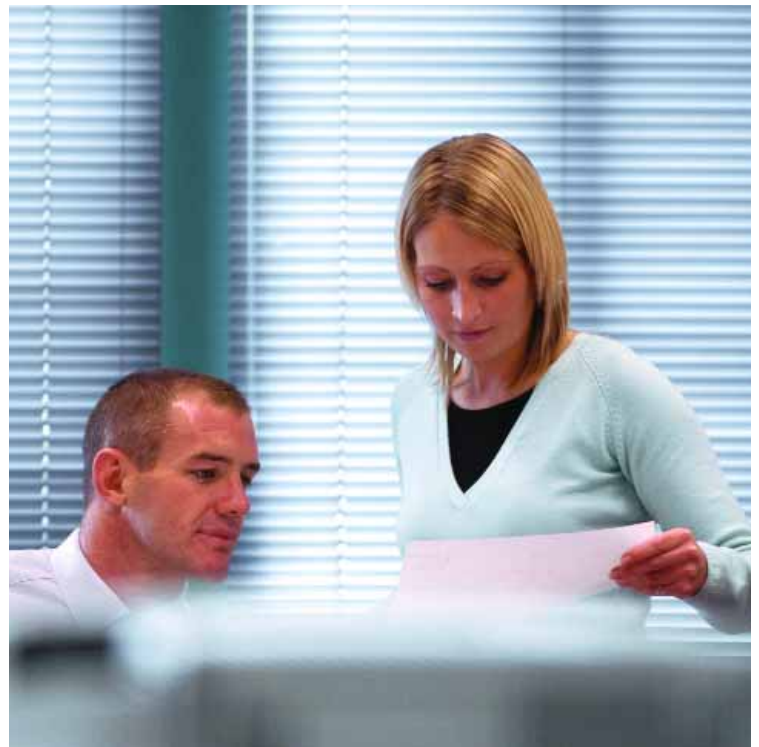
## Example

In this example we have a property developer who is constructing a health centre complex and is looking for funding over a 20 year period. The construction cost of the property is £2 million and, when established, it will generate rental income on a 20 year lease with rentals uplifted annually by RPI. 100% of the rental income will go towards debt reduction.

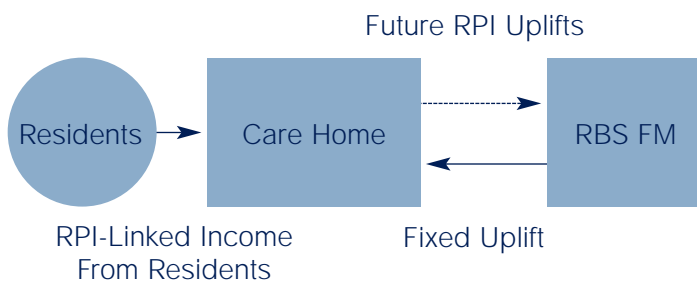


In the example above, the customer receives RPI-linked rental income from tenants in the health centre. The RPI income swap is arranged where the Bank receives the actual future uplifts in RPI from the customer and, in return, pays the borrower a fixed uplift based on a 20 year RPI swap.

The fixed uplift on the future rental flow paid by the Bank can bring greater certainty, and therefore strength, to the customer's borrowing proposal. This potentially places them in a better position to negotiate an increased "loan to property value" ratio as the fixed rental uplift generates a suitable cash flow to repay the borrowing on maturity.



A further example could be where a care home operator wishes to remove some of the uncertainty around their operating margin. For example, many care home operators have residents whose pension income and benefits are also RPI-linked and who may therefore be content to have their care costs linked to this index. By combining this with a RPI swap, net income can be stabilised. For example:



As in the health centre example, the care home operator receives greater certainty in their current and future income by receiving a fixed uplift over RPI movements.

It should be emphasised that the above RPI hedges concentrate solely on the income flows from the customer's projects. They can be combined with a number of the interest rate hedges outlined above to provide a total risk management package covering the customer's income flows and interest rate costs.

### Potential breakage costs

Additional costs may be incurred in the event that the customer wishes to come out of this arrangement, based on prevailing market conditions, such as interest rates and market expectations of future interest rate changes. This could be the case where, for example, the underlying borrowing is repaid early or re-scheduled. We will be pleased to provide examples of potential costs.

## Notes

The following notes are important

- 1 The transaction terms agreed between us verbally are legally binding contract terms. Following execution of the trade you will be required to sign legal documentation (which may include a confirmation and Master Agreement) to confirm those terms.
- 2 Telephone conversations between us may be recorded without the provision of a warning tone. These recordings are made to obtain a record of transactions and these records are our property.
- 3 The interest rate contract that you have entered into with RBS is a separate legal contract from any borrowing it may relate to. In particular, they may be terminated independently of each other and early termination of one does not automatically terminate the other.
- 4 The cost to you of the overall interest rate structure is the sum of the cost of the borrowing and the net cost to you of the interest rate contract, whether this is a swap, cap, collar or any other interest rate hedging structure. This is illustrated below  

You may have an interest rate swap under which you receive base rate or LIBOR and pay fixed. This is being used to protect interest rate risk on a loan on which you are paying base rate or LIBOR plus margin.

Your net pay/(receive) position under the swap is

Interest Rate swap	Pay	Fixed
	Receive	(Base rate/LIBOR)
Loan	Pay	Base rate/LIBOR + Margin
Net Pay		Fixed + Margin
- 5 You will be exposed to interest rate risk if there is a mismatch between the start dates or end dates of the underlying borrowing and any interest rate protection. This mismatch may be caused by circumstances such as a deferred start to the agreed protection or alternatively by delay in drawing down the loan.
- 6 You will be exposed to interest rate risk if there is a difference between the value of the borrowing that is to be protected and the notional principal of your interest rate contract with us.
- 7 If interest rate derivative contracts are closed before their maturity, breakage costs or benefits may be payable. The value of any break cost or benefit is the replacement cost of the contract and depends on factors on closeout that include the time left to maturity and current market conditions such as current and expected future interest rates.
- 8 You are acting for your own account, and have made an independent evaluation of the transactions entered into and their associated risks and have had the opportunity to seek independent financial advice if unclear about any aspect of the transaction or risks associated with it and you place, or have placed, no reliance on us for advice or recommendations of any sort.
- 9 Listed companies will have to prepare their consolidated financial statements in accordance with International Accounting Standards (IAS) for accounting periods starting on or after 1 January 2005. Comparative figures are also required for 2004. IAS 39 relates to the accounting treatment of derivatives and financial instruments in the balance sheet. If IAS 39 affects you, you are reminded that RBS is not acting as your adviser on the accounting treatment of your interest rate contract with us.
- 10 We would also draw your attention to our terms of business.

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