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Not So Great GASB: Accounting Rule Pushes Hospital Near Default.

- **Public hospitals face downgrades due to pension accounting**
- **Government accounting standard puts pensions on the books**

The financial health of Magnolia Regional Health Center, a 200-bed public hospital in northern Mississippi, has gone from fair to serious condition all because of an accounting rule.

Magnolia is in danger of breaching the covenant on a $74 million municipal-bond issue because the rule requires the hospital, whose employees are members of Mississippi's pension fund, to bring onto its books its share of the retirement system's $16 billion unfunded liability. The $127 million obligation has pushed its debts above a limit set by bondholders and may cause a default as soon as early next year — an event that would allow investors to demand immediate repayment or take control of the hospital.

In late March, Moody's Investors Service downgraded Magnolia to junk, saying default is likely if it can't strike a deal with creditors.

The Corinth, Mississippi hospital is an extreme example of how an accounting rule has shaken up the $3.9 trillion municipal-bond market by requiring the disclosure of pension debts that some borrowers were allowed to keep off the books for years. In December, Moody's downgraded bonds issued by the Spartanburg Regional Healthcare System because operating revenue wasn't keeping up with its increased debt load and said the system's participation the South Carolina retirement system would put "long term pressure" on its credit rating.

Fitch Ratings downgraded Cleveland's MetroHealth to junk last month for similar reasons.

"That additional expense is lowering their margins," said Fitch analyst Kevin Halloran. "It's going to continue to catch people's eyes."

The accounting change has posed particular problems for Magnolia because the hospital agreed to the benchmarks in its bond contract three years before the rule, known as Government Accounting Standards Board Rule No. 68, took effect in 2014. With a technical default now looming, the yield on bonds due in 2031 rose to about 4.8 percent by the end of last month from 3.5 percent in early January.

Magnolia has asked a Mississippi court for a judgment to prevent a technical default or change the bond covenants to remove the effects of GASB 68.

"Magnolia Regional has never defaulted on or failed to timely make any bond payment or other obligation, continues to remain financially viable and, through no fault of its own, is in danger of being placed in technical violation of its bond covenants," the hospital said in a complaint filed in February.

Fund Liability

In its lawsuit Magnolia cites a Mississippi Attorney General Opinion from March 2017 that individual participants aren't required to fund the liability of the state pension.

Magnolia has met with trustee Regions Bank and is seeking an agreement with investors to amend the bond covenants, said Brian Craven, Magnolia's chief financial officer. The hospital disagrees with Moody's that it will fall below a debt service ratio required by investors in the current fiscal year, he said.

"It is not out of the question that it could happen, but improved operating performance in 2018 has made this much less likely than in 2017 regardless of the performance of PERS [Public Employees' Retirement System] in 2018," Craven said.

GASB 68 requires that municipalities participating in multi-employer pensions report their proportionate share of the unfunded liability and that net pension liabilities be included on governments' statement of net assets.

There are 956 state and local government community hospitals in the U.S., according to the American Hospital Association, although it's not clear how many of them participate in multi-employer pensions.

The accounting rule is creating credit problems for the hospitals even though their operations haven't changed materially and they're making required contributions to state pensions. Magnolia contributes 15.75 percent of its annual payroll to Mississippi's pension, in addition to employee contributions of 9 percent.

When Magnolia issued the bonds in 2011, investors required the hospital to produce total income for debt service of at least 125% of maximum annual debt service for any fiscal year. If the percentage fell below 125% the hospital was required to hire a consultant to help improve operations. If income fell below 100%, bondholders could declare a default.

Taking into consideration its $127 million portion of the Mississippi's pension's liability, Magnolia had 117% total income for debt service for the fiscal year ending Sept. 30, 2017. Moody's expects the hospital to fall below 100% debt service coverage in the current fiscal year.

In March, a Mississippi court prohibited Regions from requiring Magnolia to hire a consultant through the conclusion of the case.

The outcome for South Carolina's Spartanburg Regional may be a good sign for Magnolia. When that hospital adopted GASB 68 in 2015, it booked a net pension liability of $568.6 million, sending its debt as a percentage of assets soaring to 106 percent and exceeding the covenant of below 65 percent.

But bondholders were willing to rescue it from default. They agreed to waive the covenant violation and revise their contract so the pension obligation isn't included in debt-service coverage calculations, said Meredith Moore, a Moody's analyst.

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