Prepare Now for a Healthcare Credit Pivot

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The Federal government's long-term budget challenges could mean dramatic changes for hospitals and health systems nationwide, derailing the post-COVID credit recovery that helped turn the healthcare sector into the fastest-growing segment of the municipal market in 2024.

The House Budget Committee recently began considering legislation that would reduce spending on health programs like Medicaid by more than $800 billion over the next 10 years versus current estimates. If passed, those changes and others on the table will have a direct impact on hospital revenues and credit quality. The market should also be monitoring changes that could impact the sector's costs, including tariffs, tighter limits on immigration and undocumented workers, unreimbursed research overhead, and diminishing municipal tax exemptions.

Importantly, these changes could have a lagged effect on the sector's financials. While some of these prospective moves could marginally affect providers this year, we believe the real impact would arrive in fiscal 2027, as many of these changes would likely be implemented in 2026 and therefore have a full impact in the following fiscal year. Credit analysts will need to apply a longer-term perspective to understand the emerging risks, even as published financials continue to show short-term strengthening.

The potential policy changes add significant uncertainty to the health care sector at a time when it is just emerging from a very difficult period marked by weak operations, rising costs and tight labor markets. While the sector appears poised to continue the gradual recovery that started in 2024, operating performance and other financial metrics are still generally below pre-pandemic norms.

Hospitals and hospital systems took advantage of the good news in 2024 by tapping the municipal market for $36 billion – the most since 2019, and more than double 2023's pace. Market participants are expecting solid healthcare bond issuance this year based both on the sector's recovery and pent-up capital demand. That might be a wise strategy for hospital managers: In our view, 2025 is likely to be 'the calm before the storm:'

Risks could grow exponentially going forward.

BAM currently insures more than $2 billion of revenue bonds from over 75 hospitals and health systems. The majority of ratings for these entities are in the 'A' category. While we expect some erosion of individual performance over time, we believe systems with strong enterprise profiles, like the credits in our insured book, will be able to withstand any volatility arising from new Federal policies.

Proposals Under Consideration – Direct Impact

A top priority for the Trump administration and Republicans in Congress is extending the provisions of the Tax Cuts and Jobs Act, a 2017 law that lowered tax rates for most Americans and corporations. Extending these tax policies beyond their planned sunset at the end of 2025 would cost more than $4.5 trillion over the next decade, potentially adding to an already-high Federal deficit, and setting off a scramble in Washington, DC to find cost cuts and other revenue offsets.

To get there, some lawmakers appear to be aiming directly at the Affordable Care Act (ACA) through reducing enrollment in ACA-subsidized insurance and Medicaid. While the future of the ACA itself may not be in jeopardy, there are numerous ways to shrink the number of people qualifying for ACA subsidies, even if the program survives fundamentally intact. With limited alternatives for affordable comprehensive insurance, millions of Americans will go without health insurance, which would lead to an increase in charity care and bad debt expense for providers, notably at a time when Federal funding mechanisms to support them are also being reconsidered.

Some specific proposed changes that could contribute to the House Budget Committee's $880 billion savings target include reducing the Federal Medical Assistance Percentage (FMAP), reducing the ACA extension match rate, implementing a 'per capita' cap that would limit reimbursement over time, and reductions in direct payments to disproportionate share hospitals (DSH) . There are also calls to turn Medicaid into a block-grant program. Any of these modifications would increasingly shift costs and financial risks to states. The fallout is likely to be uneven: States that have more comprehensive (and thus more expensive) programs will face tough decisions about whether to restructure their programs. If states choose to cut eligibility and/or benefits, it will materially strain providers' bottom lines, which could, in turn, put critical but unprofitable service lines on the chopping block.

Other proposed changes to Medicaid include establishing work requirements for beneficiaries and repealing waivers that allow states to grant multiyear continuous eligibility. By placing additional hurdles to enrollment, the government will further limit healthcare access and hurt sector financial performance.

Taken together, the potentially far-reaching changes in the funding of the sector could widen credit differentiation. In particular, safety net and rural hospitals that serve predominantly lower-income populations would be most exposed to negative budget fallout from those changes.

As for Medicare, there is growing interest in efforts to standardize Medicare payments across care settings, otherwise known as 'site-neutral' payments. While site-neutral payments would make sense on a level playing field, hospitals have higher overhead than, for example, ambulatory surgery centers or freestanding physician offices. Hospitals have higher overhead for many reasons, including the need to operate larger and more complex facilities, staff a wide range of medical professionals, support uncompensated care, and provide 24-hour emergency care capabilities. If site-neutral payments are implemented, hospitals and health systems will lose revenue, again lowering overall sector profitability.

Proposals Under Consideration – Indirect Impact

Additional policy proposals could have significant impacts on the national economy that might spill over to the healthcare sector. Tariffs on imports from China, Mexico and Canada would broadly raise costs, particularly in the short-term, when domestic alternatives to specific drugs, medical devices, and other supplies may not be immediately available. Similarly, increased immigration enforcement can be expected to reduce supply in the lower-wage portion of the labor pool, ultimately exacerbating existing health worker shortages, especially in rural areas.

Hospitals could also face higher financing costs if they are no longer able to borrow at tax-exempt rates, either through a broad change to municipal bonds' tax exemption, a more targeted change to block nonprofits from accessing the market, or a separate discussion about removing hospitals' nonprofit status. While changes of this magnitude would open up the health care bond market to a new and broader group of investors, a corporatization of the entire sector could be hugely disruptive. Large national systems and strong regional systems would most likely be able to adapt quickly, but we believe small and mid-sized single-site providers would have a hard time adjusting.

BAM Healthcare Sector Outlook

The 2024 recovery in sector financial metrics, while modest, was clear and convincing. It reflected improving patient volumes, better labor management, and lower inflation. Combined with strong investment market performance, selective divestitures of under-performing assets, continued cross-market M&A, and tighter cost containment measures, these factors set hospitals and health systems on a sustainable and positive path forward.

That being said, we do not believe fiscal 2024 and 2025 results provide the insights needed to make long-term credit decisions. We note that all three rating agencies published 'stable' outlooks on the healthcare sector, but these outlooks focus narrowly on short-term expectations for the direction of ratings in the year ahead, while these other policy debates will have significant implications for the future of healthcare as a whole.

In our view, for the reasons outlined above, 2026 and beyond will be the years to watch to determine where health care is headed. The deep, post-pandemic downturn may be over, but the current stream of favorable audits and interim results should not be mistaken for an 'all clear.'

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