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## Liquidity Meets the New Normal

By Brett Whysel

For health systems today, ample liquidity means “never having to say you’re sorry”<sup>1</sup> to your creditors, your board or your community. Across the country, executives are asking us, “When will things return to normal?” My answer: “Manage your liquidity as if this *were* the new normal.”

Health system managers are asking other questions: How can we get enough bank credit? When can we issue fixed-rate bonds at reasonable rates? When will our swaps get back “in the money”? And, when will we be able to stop worrying so much about investment losses and pension funding? From my perspective, these questions reflect both 1) a renewed focus on liquidity, and 2) wishful thinking. We may never return to normal, if “normal” means the virtually free-money, high-growth, low-inflation, low-regulation environment we enjoyed from 1993 to 2007. So the better questions are: what is the new normal<sup>2</sup> and how do we respond?

The past 18 months have been tumultuous for healthcare CFOs, treasurers, bankers and advisors. The implosion of the auction rate market, collapse of the bond insurance industry, bank retrenchment, spike in credit spreads and the ensuing Great Recession of 2008 have decimated health system balance sheets, reduced elective surgeries, impaired cash flow and left us all wondering if there’s more bad news coming. We’ve become less trusting and confident, more risk-averse and in need of a new game plan. It’s gotten so bad that the market cheered the most recent announcement of 9.4% unemployment because the rate of job losses decreased from the previous month.

We want to believe that the slightly improved market outlook means the beginning of our return to “normal.” That’s just not realistic due to fundamental changes in the economy. The global banking system is undercapitalized (perhaps even collectively insolvent) and unable to lend freely. The once-flush “shadow” banking system of aggressive hedge funds and off-balance sheet structured financing vehicles has evaporated—so no liquidity there. Government stimulus can replace only a fraction of the lost liquidity (via TARP, TALF, TLGP, ZIRP, etc.). While confidence will recover over time (it always does), banks will take less risk and offer less liquidity due to greater regulation and market scrutiny.<sup>3</sup> We expect this will limit economic growth and inflate risk premiums. Steeper yield curves, wider credit spreads and more expensive bank credit are expected to be with us for a long time. Welcome to the **new normal**.

**Liquidity** today is both a fundamental risk and a strategic business tool in the new normal environment of unexpected cash drains and impaired assets. Despite all the attention, liquidity remains an amorphous concept. For our purposes, liquidity represents a health system’s ability to access funds, as needed, through borrowing, liquidating assets or operating cash flow. This concept divides into two: asset liquidity and funding liquidity.

**Asset liquidity** measures a system’s ability to liquidate assets (or extinguish liabilities). In better times, health systems can sell

investments (or unwind swaps) at verifiable market prices. Alternative investments are well known for their limited asset liquidity. In worse times, some assets may not trade at any price (think post-bankruptcy Lehman swaps). Moody’s Investors Service has indicated it will be looking more closely at asset liquidity, requiring systems to provide additional data, including categorizing funds by their ability to be liquidated within a day, a week or a month.<sup>4</sup> Asset liquidity is important because it translates the system’s wealth into the cash it can use to meet unexpected funding requirements.

**Funding liquidity** measures a system’s access to credit from banks, investors and vendors. It’s important because it measures the system’s ability to tap external sources to meet funding requirements. The level of a system’s funding liquidity depends on factors such as:

- organizational cash balances and cash flow,
- investment allocation and performance, as well as philanthropy,
- availability of letters/lines of credit,
- ability to remarket VRDOs and put bonds,
- collateral posting and termination payments for swaps; and
- pension funding status.

The emphasis on liquidity in the new normal will lead analysts to weight days-cash-on-hand, cushion and debt-to-cash-flow ratios more heavily in assessing a system’s credit strength. Newer liquidity measures, such as cash-to-VRDO par, will become standard components of credit assessment. Finally, enterprise risk modeling (and its limited cousin, asset-liability management) will need to incorporate liquidity risk and its relationships to market, credit and business risks.

In practical terms, systems should take steps to maximize and diversify liquidity sources, as well as limit potential drains. Steps to consider include:

- limit use of variable rate debt instruments,
- stagger and lengthen put bond remarketing dates,
- diversify bank credit sources and swap counterparties,
- actively manage swap market-to-market volatility,
- reallocate investments to cash and other more liquid asset classes,
- manage, measure and monitor assets and liabilities programmatically,
- delay non-critical capital expenditures,
- risk-adjust projected returns in capital budgeting,
- minimize endowment spending,
- convert from defined benefit to defined contribution retirement plans,
- sell non-core assets and receivables; and
- evaluate securitization and revenue cycle improvements.

Clearly, liquidity is now at the nexus of health system financial management. It links and influences business performance, borrowing, investing, hedging and risk management. So, it is critical that health systems evaluate sources of liquidity risk and test their ability to withstand stressful liquidity events. We have seen that liquidity events.

We have seen that liquidity events rarely occur in a vacuum. Systems should assess the liquidity risks embedded in their debt, investments, hedges and operations. Creating robust contingency planning for scenarios that, until 2008, seemed too remote to worry about should become a regular feature of enterprise risk management.

Liquidity is now a strategic asset. Systems can use it to buttress their balance sheets and credit ratings, support operations, protect investments and enhance bargaining power. In the new normal, stakeholders demand, "Show me the [liquidity]!"<sup>5</sup>

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<sup>1</sup>To take liberties with Ali MacGraw's famous line in Love Story, 1970.

<sup>2</sup>See "A New Normal," PIMCO Secular Outlook, May 2009, by Mohamed El-Erian.

<sup>3</sup>Ibid, quote "The banking system will be a shadow of its former self. With regulation more expansive in form and reach, the sector will be de-risked, de-levered, and subject to greater burden sharing. The forces of consolidation and shrinkage will spread beyond banks, impacting a host of non-bank financial institutions as well as the investment management industry."

<sup>4</sup>Moody's developing new liquidity ratios for U.S. hospitals, Healthcare Finance News, April 23, 2009.

<sup>5</sup>To even more unfairly paraphrase Cuba Gooding, Jr. in Jerry Maguire, 1996.