The Risk Factor

We've got in-depth advice on finding the sweet spot between investment and liquidity.

When the financial crisis hit in 2008, few health systems were prepared. Neither was anyone else. With the market dropping like a rock and liquidity drying up, to say it was a financial catastrophe isn't an exaggeration.

In the three years since the financial crisis hit and receded, hospital CFOs have learned some tough lessons. A major legacy of the financial crisis is the importance of liquidity on a hospital's balance sheet. Good and bad markets come and go, and the way to ride out both the lean and prosperous times is with a strong cushion of liquidity.

Liquidity isn't just about stockpiling cash. It's about managing various facets of a health system's finances, including investments, spending, capital expenditures, mergers and strategic alliances, and other issues. It's also about living up to bond covenants and rating agency evaluations.

"Risk has become a very important focus with health systems in the past couple of years," said Christopher La Marca, healthcare investment director of the Solutions Advisory Team at SEI Institutional Group in Oaks, Pa.

"The focus on risk has become much more important since the financial crisis," he said. "Hospitals were impacted in several ways, including drawdowns in investment value that impacted a lot of liquidity measurements, such as days of cash on hand and cash-to-debt ratios. Those saw declines, and hospitals were negatively impacted in terms of rating agencies. Banks also became more cautious, and credit support dried up."

By subjecting multiple aspects of your health system's finances to liquidity-based scrutiny, you can get a better handle on liquidity right now and in the future, whether the future holds another financial crisis or garden-variety belt tightening in the form of Medicaid and Medicare cuts. Here are some areas to look at.

Investment risk

There is no potential reward without risk, of course. But if there's too much risk, volatility and an unfortunate confluence

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of events, such as the financial crisis, can rock your institution's financial world.

A diversified investment strategy that places an emphasis on preserving capital and liquidity is a sweet spot for most health systems because it doesn't make sense to take too much risk, but completely eschewing risk means losing out on potential returns. South Nassau Communities Hospital in Oceanside, NY went into the financial crisis with a 75% to 25% stocks-to-bonds split in its investment portfolio, and it preserved that balance during the bear market, despite some pressure to liquidate investments, said Mark Bogan, vice president for finance.

"Our feeling was that to liquidate investments at that low point in the market would only memorialize those losses. It would have taken us a decade to get back to where we were previously," he said. "We felt that a recovery would happen, and it did."

Subsequently, the hospital did diversify the part of its investment portfolio that is unrestricted (the self-insurance pool for malpractice and the unrestricted pension funds) into some alternative investments, including a hedge fund fund of funds.

Capital expenditures

Like investment risk, capital expenditures also have two aspects: capital improvements cost a lot but potentially bring in more revenue than day-to-day expenses. However, capital budgets are an easy target, and it does make sense to prune to save cash when times are really tight. That's one of the first places that South Nassau Communities Hospital went to cut back on expenses.

"When we saw the market go through its initial hiccup in 2008, the first thing we did was tighten our belt on capital spending," Bogan said. Eventually, the budget increased again, but initially when liquidity dried up, it was a fairly easy place to make some cuts, he added.

Mergers and alliances

Consolidation in the healthcare environment is a long-term trend that isn't likely to change, noted La Marca. "What we're seeing in healthcare is some of the weaker organizations looking to align themselves strategically with stronger systems to create economies of scale," he said. "This helps reduce some overhead and expenses ahead of healthcare reform."

It makes sense for smaller institutions to at least ally themselves with larger ones, if not outright merge, he added. "Some hospitals are looking to be more preemptive and align themselves strategically with other institutions before they find themselves behind the curve in a couple of years."

Revenue cycle management

The revenue cycle is an area that can yield savings and increase liquidity. South Nassau Communities Hospital put a lot of time and effort into reducing its days in accounts receivable. In 2003, when Bogan came on board, the average was 70 days; last year it was 45 days, and the goal is to get it down to 40 days in 2011.

The fewer days, the better, as it means the hospital is collecting on its outstanding bills more quickly, meaning the hospital has access to cash faster than it did in the past. Bogan notes that reducing the days in accounts receivable from 54 to 48 between 2008 and 2009 yielded $6 million in cash that the hospital really needed at that time.

While liquidity isn't a silver bullet, it's an important component of a sound cash management strategy. "Hospitals want to preserve capital, but going all cash is not necessarily the answer," said La Marca. "What you want is a conversation not merely about liquidity, but about capital preservation. You don't want to sacrifice too much on the upside, but you want to protect the downside."

Bogan agreed, saying: "You can't hoard cash or refuse to make long-term investments in your facilities. Otherwise, you get into a never-ending spiral where you can't cut enough to stay in business. I would suggest that as scary as times are and as important as liquidity is, you still have to look at your organization and make smart investments in areas like technology and capital improvements." ✚

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