There is little debate that the current and expected future environment is one of the most daunting in history for healthcare finance executives. The challenge to keep their organizations financially viable while facing cost pressure from every conceivable direction is constant. New, innovative strategies need to be developed, and healthcare organizations have never been more dependent on external expertise from their various partners. This perspective touches on the current environment and outlines how an integrated approach to investment management can help address some burdens.

The Current Environment and Impact on Organizational Finances

By the end of February 2011, all three major credit rating agencies had released their yearly outlook on the non-profit healthcare sector. Though the agencies did not agree on the overall outlook for the year, their views on the future are similar in that they have significant concerns. While both Standard and Poor’s (S&P) and Fitch have stable outlooks on the sector for 2011, they both left open the possibility for a downgrade should financial conditions worsen. Unlike the other two, Moody’s issued a negative outlook on the sector for this year, in part because they feel that many of the future concerns have already started to materialize. From an organizational finance perspective, the expectation is that most healthcare organizations face significant challenges in three distinct areas:

1. **Revenues**
The general outlook is for decreased revenue from all major payers including Medicare, Medicaid, commercial insurers and overall donations. The reasons for the expected decrease range across state and federal reductions in reimbursements, membership losses on the commercial side, and the expiration of stimulus spending in June of this year. Revenues will be further impacted by declining volumes, an increasing number of under-insured or uninsured patients and the expiration of COBRA benefits tied to high levels of unemployment. These factors will push declining utilization, higher charity care and higher levels of bad-debt expense (uncollectable receivables from self-pays).

2. **Expenses**
Many healthcare organizations are finding it difficult to further reduce expenses after two straight years of doing so. Further reductions will also be difficult in light of the cost of implementing healthcare reform. However, higher costs of capital will play a large part in increasing pressure on healthcare organizations to cut costs.

3. **Balance Sheet**
These additional costs come at a time when one could argue the need for capital access has never been greater. The sector has large expenditures on the horizon given Information Technology (IT) requirements related to healthcare reform and deferred capital spending over the last two years. Other strains on the balance sheet include under-funded pensions and negative swap valuations forcing collateral posting.
A Day in the Life of a Healthcare Finance Executive

The overall operating environment has made it incredibly difficult for healthcare finance executives to manage the above three components that make up the financial health of the organization. Fundamental to the financial management of a healthcare organization is the effective management of the balance sheet to support short- and long-term borrowing goals.

The borrowing environment for healthcare organizations has almost never been more difficult than it is today. Fixed-rate alternatives are becoming increasingly expensive, as spreads related to the credit risk of the sector widen and general rates for all municipals trend higher around continued uncertainty around the municipal market. Recently, BBB- investment grade tax-exempt healthcare bonds were trading near corporate junk bond levels.

The end result is simply a diminished supply of credit. Creditors are providing “take it or leave it” offers that often come with very onerous covenants to the borrowing organization. Many healthcare systems and hospitals are shifting from variable-rate debt into fixed-rate debt and all of this has forced executives and Boards to make critical financial decisions based on the difficult conditions related to such covenants.

Healthcare finance executives are faced with the difficult task of finding ways to incorporate the conditions of these onerous covenants into the ongoing financial goals of the organization. They need to understand the impact, make critical decisions, and must develop strategies to minimize the impact these conditions have on the overall goals.

How Can Integrating Investment Management Help?

Healthcare finance executives, boards and investment committees are being forced to deal with all of these complicated issues on almost a daily basis. Historically, most institutional investors, including healthcare organizations, had an investment management approach with primary objectives focused on total portfolio return. As volatile capital markets and unpredictable interest-rate levels have continued, many organizations have made risk management their primary objective when it comes to investing the portfolio. The need for an integrated approach to the management of unrestricted assets and overall finances has never been greater.

Below are a couple of examples of how by taking a more organizational risk focused approach to investment management, healthcare finance executives can more effectively draw conclusions around some critical questions and potential impacts portfolio changes can have on business objectives:

1. One example would be a creditor insisting on a dollar-for-dollar match of all variable-rate exposure, essentially requiring the organization’s unrestricted invested assets be pledged to the creditor. The decision to enter such a covenant must consider the “domino impact” on all of the various financial objectives of the organization. For example, what if in attempting to accommodate the creditor’s request, the organization also has a financial goal of staying within predetermined performance bands around “days cash on hand” and “cash to debt ratio?” The organization would need to create a cash reserve large enough to pledge to the creditor while also trying to generate enough investment returns to stay within the targeted credit metrics. In the event returns are below expectations, this puts additional pressure on operations to support balance sheet growth.

From an investment standpoint, the asset allocation needed to support these goals would be conflicting, with one allocation being detrimental to the other goal. If investment management is integrated into the overall business process, asset allocation decisions
could be made to support both goals. One solution might be to separate the unrestricted investments into two pools with distinct asset allocations. One pool would be the cash reserves equal to the amount of newly issued letters of credit, and the other pool would be to implement a return enhancement strategy. The first pool could have an asset allocation of cash and shorter-duration fixed income to help negate principal risk associated with market volatility and interest rates movements. The second pool could have a diversified, return-focused allocation featuring domestic large- and small-cap equities, international equities, real estate and alternative investments.

2. A second example of how a focus on organizational risk in portfolio decisions can have a positive impact would be if an organization had a primary objective of maintaining and improving its existing “Debt to Capitalization” ratio. From an investment standpoint, this objective would create a need to control volatility, match or exceed the organization’s interest expenses on its debt, and generate sufficient returns to buffer the amount necessary from operations to rebuild the balance sheet. Understanding these business objectives when making asset allocation decisions could lead to the decision to reduce equity exposure while increasing the allocation to fixed income, with an emphasis on duration designed to minimize interest-rate risk. These changes would be designed to decrease the portfolio’s standard deviation while still maintaining acceptable levels of return.

These are very specific examples but give insight into how many various challenges healthcare organizations face when making financial decisions. Considering the invested assets and their allocations is a critical part in addressing the system’s overall financial concerns.

The invested assets impact almost all business objectives. What if the organization is also trying to decrease the variable-rate exposure of its total debt portfolio? What if poor operational results are forcing the organization to draw on unrestricted investments and it wants to increase its cash position? What if the organization is looking to make an acquisition or be acquired? What happens if creditors are forcing termination or orphaned swaps when the swap’s mark-to-market is negative? These are the types of questions that should be considered when building a strategic portfolio allocation, not an allocation that just gives the potential for the best opportunities for return.

Gone are the days when the organization’s investment committee designed return-focused asset allocations in a vacuum away from other business discussions. Integrating these investment decisions with the organization’s financial objectives is the new model - and a critical change many healthcare systems are currently adopting.