

"Anatomy of a Market Meltdown"

BY CRAIG T. STANDEN, SENIOR VICE PRESIDENT, ZIEGLER CAPITAL MARKETS



The effects of the rapid and continuing decline of the sub-prime mortgage market over the last six to eight months have spilled over into the broader credit markets and the municipal bond markets have not been spared. Mortgage-backed securities tied to sub-prime mortgages have declined dramatically in value resulting in eventual write-downs of between \$300-500

billion (and counting) by leading financial institutions, including investment banks, commercial banks, hedge funds, institutional bonds and money funds, along with municipal bond insurers to name a few.

In particular, the municipal bond insurers' exposure to the sub-prime mortgage market has resulted in heightened rating pressures for some and the loss of the coveted "AAA" ratings for others, which has driven the \$350 billion municipal insured auction rate and the \$400 billion insured variable rate demand bond mar-

kets, specifically, into states of dysfunction bordering on paralysis.

As these events unfolded over the past number of months, investment bankers and financial advisors were fielding regular calls from their healthcare borrower clients who were asking, "How will this affect my organization?" More recently, however, the tone of the calls are more like "This is killing me; how can I get out of these markets?"

The goal of this article is to provide healthcare borrowers and other interested parties with some perspective on (1) the challenges

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MAKE A DIFFERENCE

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Highlights and Recap
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■ New Online Program Registration for First Illinois Chapter HFMA

First Illinois Chapter HFMA recently moved to a more efficient Program Registration process for online Program Registration. As our program volumes continue to grow, we want to ensure we are utilizing the most efficient, secure, state of the art technology for our electronic interfaces with our membership, including our online Program Registration technology and processes. We have contracted with a company called “CVENT” who is a nationally recognized Event Management company. CVENT works with many HFMA chapters across the country and has greatly improved the efficiency of the Program Registration process for those chapters.

The changes to Program Registration process will be transparent to our members. The Program announcements/invitations sent via email will look exactly like the emails you’ve historically received from HFMA; but the emails will actually come from CVENT, identified by “event-FIHMFA.org” in your “From” line in email. We believe that most all of our membership is receiving the Program Announcements via email from CVENT without disruption.

To ensure that all First Illinois Chapter HFMA members continue to receive our emails regarding our Programs & Events, we are asking our members to check their Spam/Junk Mail/Blacklist boxes for emails from “event-FIHMFA.org”, and pull any emails from “event-FIHMFA.org” into your Whitelist to allow you to continue to receive our Program Announcements.

Based on HFMA’s experience with CVENT, this issue affects a very small number of members, but to be 100% certain we are sending all of our members this information. We will continue to mail paper copies of our Program Announcements, and accept paper/fax Program Registrations as well. If your contact information has changed at all, please confirm the changes to via www.hfma.org, which is the source of our information for member communications.

Thank you for your continued support of First Illinois Chapter HFMA, and for your attention to this matter. Please feel free to call me at 630-928-5233 if you have questions, comments or concerns. ☎

Letter from the President

Opening Day of the 2008 baseball season is here; spring has sprung! You’d never know by the weather, but it won’t be long until summer comes.

Recent events in the hospital industry have put a spotlight on what people routinely refer to as a system of “haves and have nots”. Last week St. Francis Hospital and Health Center in Blue Island announced it was closing, having lost some \$40 million dollars in the past couple years. Later that week there were two front page newspaper articles on the non-profit hospital industry; the first on 4/4/08 was a cover story in the Wall Street Journal, and the second was the 4/6/08 cover story on the Chicago Tribune. Both of these articles highlighted how some hospitals do very well financially, and others do very poorly financially.

This chain of events has heightened the discussion on hospitals, and healthcare overall. There two (2) central themes: First, the probability of a hospital’s or any healthcare provider’s financial success is directly correlated to its location and payor mix, and second, healthcare has become a complex business full of contradictions and implications for all its stakeholders. If we truly believe as Americans that our healthcare system should be the best, centered in things like EMRs, and other quality-enhancing technologies, then we need to find a way to make that possible for all hospitals, doctors, and healthcare providers, not just those afforded a good location and an attractive payor mix. And we fundamentally need to decide how we feel about the profit vs. non-profit aspects of healthcare, on both the delivery side (i.e., hospitals and healthcare providers) and the financing side (i.e., payors).

This is my last “President’s Message” as First Illinois HFMA President. As we do every year, come June we will rotate leadership and I will hand over the wheel to Guy Alton, who will become your next President. It’s been a great year for me personally, and I hope you our members feel that HFMA is still providing you with the benefits, services and educational opportunities you’ve come to know and expect from the largest healthcare financial association in the country. I would like to take this time to thank all the volunteers within HFMA who work so hard to make our chapter run so well. First Illinois is one of the largest HFMA chapters nationally, and we provide a high volume of programs and events, all coordinated and orchestrated flawlessly by our hardworking committee members and volunteers.

In closing, I’d also like to thank each of you, our valued HFMA members, for making my year as your President so rewarding. I’ve met many people this year, and everyone I meet reminds me of what great people we have in this industry, and what a great industry we work in and commit ourselves to. I can tell you that I have a much greater appreciation for that today than I did a year ago.

Best wishes to you and yours,
and keep fighting the good fight! ☎

Jim Watson
President
First Illinois Chapter
HFMA



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First Illinois Chapter News, Upcoming Chapter Events & Committee Updates

■ Membership Committee

Membership Directory Update

We recently discovered that the following members were inadvertently omitted from the 2007-2008 Membership Directory, distributed last fall. The cause of the oversight was a database extraction procedure which has since been identified and corrected. First Illinois/HFMA sincerely regrets the error and for any inconvenience caused to our membership.

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Letter from the Editor

Spring has arrived and the season has officially started, however, the warmer weather seems to have a slow start. As the temperatures keep rising and the snow keeps melting, we are reminded to be patient as a wonderful season is on the horizon. I can't wait to see all of the tulips in full bloom! In celebration of spring, I have chosen yellow for this newsletter. Hopefully the color will stick out in your piles of mail and it will not only grab your attention but also brighten your day.

This is the last newsletter for this year, but I have accepted the position of newsletter editor for one more year. I hope that our members continue to feel that the newsletter and its content are an additional benefit to their membership in the First Illinois Chapter of HFMA.

As the new chapter year begins, I am almost out of articles for the future newsletters. Therefore, if you have an article that you think may be of interest to other members, please forward them to me. I try to get as many articles as possible into the newsletters to keep everyone updated on all of the changes in healthcare.

To make sure you don't miss any of the information in this newsletter, here's a summary:

Articles

1. Anatomy of a Market Meltdown
2. Step Outside of Your Comfort Zone...Observations and Reflections on Healthcare Financial Careers

Committee Updates

1. Updates to the Membership Directory
2. CVENT Information

HFMA Event Recaps

1. Founders Merit Award Recipients
2. Access Takes Center Court
3. Managed Care "Spring Training"

HFMA Upcoming Events

1. 32nd First Illinois Chapter HFMA Golf Outing
2. Annual Meeting
3. First Illinois Diamond Anniversary Ball

As always, if you have an article for future newsletters, please forward them to my attention. 📧

Amanda Springborn
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HFMA Events

Founders Merit Award Recipients



Brian Sinclair & Liz Simpkin - Silver Award



Gail Walker, Gold Award



Pam Waymack, Silver Award



Jim Watson, Silver Award



William DeMarco, Bronze Award

HFMA Events

Access Takes Center Court

March 6, 2008 aIPAM Conference at OakBrook Bath & Tennis Club

BY KATHERINE MURPHY

The March 6th aIPAM conference, was attended by approximately 140 people and proved to be a bright spot for everyone. The program education session was multifaceted in topics and included: the latest and greatest in Patient Access Technology, a legislation update by the IHA, leadership, human resources, the FBI regarding Healthcare Fraud and the finale of *The Good, The Bad and The Ugly* (presented by Clint Eastwood – AKA Jim Heinking). Jim's presentation was a big hit with the audience and as you can see from his photos – he spared nothing to make a REAL statement!

Attendees were treated to mini-massages by Massage Envy throughout the breaks and lunch. Guests also enjoyed cocktails and a raffle at the conclusion.

Mark your calendars now for the fall aIPAM conference scheduled for October 2, 2008 at The Hyatt Lodge located on the McDonald's Campus in Oak Brook. ☎



aIPAM Conference in full swing



The Good, the Bad, and the Ugly



Olivia Gutierrez & Katherine Murphy

HFMA Events

Managed Care “Spring Training” Thursday, March 20, 2008

BY GRACE DAIGEL

It was like a breath of fresh air. On March 20th, the first day of Spring, First Illinois held its annual managed care conference at the University Club in downtown Chicago. Some highlights from the day:

Dr. Terry Fouts, Senior Vice President and Chief Medical Officer of Great-West Healthcare, presented how managed care is not just about rates and utilization management anymore. There is a business case for promoting wellness.

Elena Butkus, Vice President of Finance for the Illinois Hospital Association, gave us an overview of the most relevant bills pending in the Illinois Legislature. She also updated us on developments with the Certificate of Need requirement, laws affecting Quality and Patient Safety reporting, Workers’ Compensation, Tax-Exemption and Charity Care.

Liz Simpkin, President of The Lowell Group, moderated a thought-provoking discussion with executives from some of Chicagoland’s most prominent managed care companies:

- Aetna – Dr. Burt VanderLaan, Regional Medical Director
- BCBSIL – Bill Patten, Senior Director of Professional Network Management
- Cigna – Sue Podbielski, President and General Manager for the Midwest Markets
- Humana – Paul Butler, Vice President of Network Management
- United Healthcare – Michelle Lobe, Vice President of Network Management



Bridget Gibbons

This illustrious panel addressed:

- approaches to pay-for-performance
- what employers are looking for
- whether payers have a role in helping to fund provider efficiencies, such as EMRs
- consumer-driven health plans and what is being done to help providers collect increasing amounts of patient responsibility
- Medicare Advantage plans

Sue Podbielski said that what their customers are looking for are transparency, consumer education, value as a partner, and renewal predictability. With regard to the funding question, Paul Butler commented that there is a business case for such funding — “How much are we going to save collectively?”

The panel also fielded questions from the audience. What percentage of claims are electronic? Bill Patten commented that BCBSIL tracks this percentage as an Administrative Efficiency and BCBSIL’s percentage is 95%. What is value-added on a Medicare Advantage plan? An attendee commented that there have been multiple iterations of Medicare managed care attempting to enter the market. What are the practices regarding retrospective outsourced audits? The concern was that there is a lack of consistency and subsequent lack of accountability regarding interpretation of contract terms. As one attendee asked, “What are the rules of engagement?” From a payer perspective, Dr. VanderLaan commented there may be more claims that are hitting a “take notice” threshold. Michelle Lobe commented that reimbursement methodology affects whether a claim is audited.

Bridget Gibbons, Vice President of Finance at the Neurologic & Orthopedic Hospital of Chicago, walked us through how to calculate Medicare inpatient reimbursement, including calculations for Disproportionate Share (DSH), Indirect Medical Education (IME), and Outliers.

Keith Kudla, President of Illinois Harmony/Wellcare, addressed the debate



Elena Butkus

over whether Medicare Advantage (MA) plans are overpaid. He contended that the commonly quoted statistic about how 12% more is spent on MA than original Fee-for-Service Medicare is really a myth. He described how CMS establishes benchmarks for every county in the United States and how there is wide variation in the benchmarks. He also described an MA bid and how 75% of the difference between the bid and the benchmark is used for added benefits for enrollees.

Dr. Kaveh Safavi, Chief Medical Officer of Thomson Healthcare, discussed trends in hospital demand, reimbursement, hospital financial performance, clinical performance, and consumerism. Dr. Safavi noted that Medicine (compared with Surgery, Mental Health, Newborn, and Women’s Health) accounted for 62% of growth in inpatient cases. Renal Failure and Dialysis experienced the biggest increases. With regard to consumerism, Dr. Safavi characterized the Quality Driven Consumer (i.e., someone likely to research ratings information on hospitals or doctors and likely to change hospitals if preferred hospital received a low rating) as wealthy Baby Boomers and Generation X’ers. Quality Driven Consumers are more interested than others in information about medical conditions and their physician’s background. Quality Driven Consumers however only represent one out of five U.S. Adults and 76% of consumers overall would not change physicians for poor ratings.

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HFMA Events

Managed Care Spring Training (continued from page 6)

Jeff Teske, partner at Hogan Marren, brought his wealth of antitrust law expertise and addressed the importance of clinical integration for joint negotiation/contracting and discussed the indicia of “real” clinical integration. He addressed how the electronic medical record (EMR) fits into clinical integration.

The Managed Care Committee wishes to thank all our speakers and our over one hundred attendees for making our “Spring Training” a great event. We also thank Great-West Healthcare for its generous support of this year’s Social Hour reception after the program.

Sure, Chicagoland got walloped by a Winter snow storm the very next day, but we Spring ahead having gained knowledge and inspiration from our managed care conference.



Managed Care, Bill Patton, Paul Butler, Sue Podbielski, Michelle Lobe, & Burton VanderLaan, M.D.

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UPCOMING EVENTS

Watch Out and Save The Date!!!

First Illinois Chapter - HFMA Golf Outing is May 23, 2008

The 32nd First Illinois Chapter HFMA Golf Outing will be held on Friday, May 23, 2008 with the primary scramble location at St. Andrews Golf and Country Club and the Klein Creek Golf Club for regular play.

All participants in our outing will receive a golf gift of a Callaway Watch – Men and Women will have two styles to choose from and there will also be Callaway staff onsite at St. Andrews to adjust watch sizes.

For early bird golfers, an early barbeque will be held from 11:00 AM to 1:00 PM outdoors, weather permitting.

Our regular networking barbeque will be held after golf – the barbeque opens at 3:00 PM and runs until 7:00PM.

Sponsorship opportunities for this fun and well attended event are still available!

For more information, contact Ross Stebbins, Golf Committee Co-Chair for more information via email at ross.stebbins@rsmi.com or at (847) 413-6918. Get your tee times booked before they fill up!!!



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Step Out Side of Your Comfort Zone

Observations and Reflections on Healthcare Financial Careers

BY LINDA KLUTE, TATUM LLC

EXHIBIT I - SKILLS AND EXPERIENCE CHECKLISTS
SOURCE: Tatum LLC Recruiting Guidelines
What have you done to-date and what would you like to add to your portfolio?

Experiences	Past Experience - D = Basic, I = Intermediate E = Expert	Goal - Experiences to seek
Type of healthcare company		
• Provider		
o Acute care		
o Other		
o Physician practice		
• Payer, insurance company		
• Long term care		
• Home health, hospice, other post-acute		
• Managed care company		
• Life science, CRO or pharma		
• Device		
• Imaging, lab, ASC		
• Technology developer/vendor		
• Other healthcare business		
Type of company experiences		
• For-profit		
• Not-for-profit		
• For-profit - public company		
• Billion \$ company		
• Start-up company		
• Turnaround/wind down/bankruptcy		
• Union environment		
• Mergers, acquisitions, divestitures		
• IPO		
CFO - Required experiences		
• 5-10 years as CFO - at least some within companies with revenues of \$50 million or more		
• 15+ years financial management, preferably within multiple companies, in different industry segments		
• Proven success providing financial leadership and managing business during a transition		
• Established professional network		
CFO - Desirable experiences		
• Capital raising - both debt and equity		
• Public accounting or financial consulting		
• Equity (IPO, SEC reporting, private equity funding, investor relations)		
• Mergers, acquisitions, divestitures (deal negotiation, due diligence, integration)		
• Knowledge of SEC requirements, public filings, SOX		
• Cost/ownership, cost accounting, activity based accounting		
• Treasury		
• International (funding, tax, consolidation)		
• Tax		
• Human resources, risk management		
• Legal		
• CPA, MBA, CMA other credentials		
Principal Controller - Required experience		
• 5-10 years of controlship, at least some within companies with revenues of \$50 million or more		
• GAAP reporting, internal controls, financial systems, cost accounting, audit, management of staff level employees		
• Interface with all levels of management		
Desirable experience		
• Current licensed CPA		
• Dir of report to CFO		
• Tax and audit processes		
• Interaction with auditors, bankers, outside counsel		
• Evaluation and re-design of financial systems		
• Assessment of financial statements		
• Oversight of treasury function		
• Knowledge of SEC requirements, preparation of public filings, internal controls		
• Sarbanes Oxley documentation, assessment and certifications		
• ERP systems		
• Budget development (department, capital, consolidated)		
• Established professional network		
Additional Requirements - Healthcare - all candidates		
• Knowledge of the industry as a whole, not just sub-segment		
• Experience/participation in management of:		
o Strategic goals		
o Cost control		
o Strategy and governance		
o Capital acquisition/management		
o Accounting, reporting, controls		
Additional Requirements - Healthcare - Revenue Cycle		
• Experience in each of the following areas:		
o Access		
o CDM		
o Charge capture		
o Business office		
o Denial management		
o Managed care contract negotiations		
o Customer service		
• Increased responsibility within the department		
• Consulting and project management		
• Product/process development		
• Clinical experience a plus		
Other		
• Variety in size of companies during career (experience in a variety of sizes desirable)		
• Variety in maturity level of company during career (experience in various stages desirable - start ups through established; experience in managing troubled situations desirable)		
• Variety in setting - urban/inner city, metro, rural,		

Healthcare is an enormous industry with many career paths, so taking the time to consider professional development is an important activity for each of us. Even those who are not currently seeking a job change can benefit from a self-examination of experience and skills. The following observations serve as a checklist for professional development for CFOs, controllers, and other financial managers.

Experience Portfolio Assessment

Healthcare management recruiters look for professionals with well-rounded career experience who have a desire to leverage and accelerate their experience base by providing services to their clients. They seek individuals with a sense of adventure and the confidence to take on new challenges within a wide variety of settings. Completion of the skills and experience checklists for financial and healthcare professionals in Exhibit I is an excellent exercise for assessing your past experience and determining goals for the future.

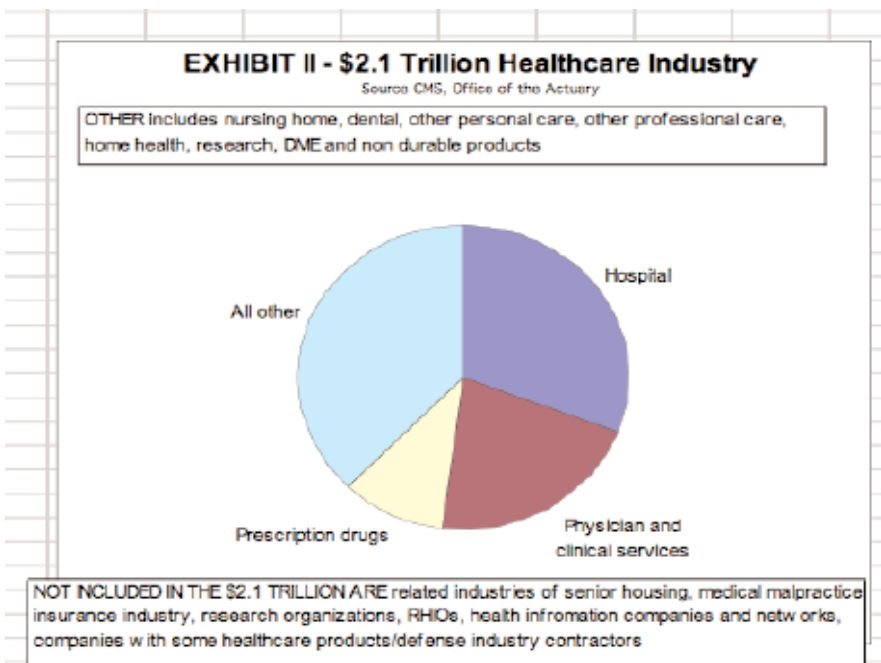
A Broad View of the Industry

While HFMA includes members from

every slice of the healthcare industry pie (Exhibit II) and the healthcare marketplace swirl (Exhibit III), the explicit and implicit focus of HFMA is often on acute care. Obviously acute care is an important part of the healthcare industry pie, but there are so many other slices and ingredients. If your experience is provider-based, ask yourself about your understanding, experience in and appreciation of other areas (e.g., payer, supplier, vendor, advisor, other types of providers, etc.). Also, evaluate how diversified your experience is within the provider space. Have you worked in both for-profit and not-for-profit settings? Do you have work experience in ambulatory, home health and acute care? For those in the payer and supplier/vendor slice, would it be beneficial to walk in the shoes of "the other side" for awhile.

We often hear in HFMA circles about the differences between provider members and vendor members. This perceived division can represent a narrow, skewed and dangerous point of view for the healthcare industry as a whole. We may have different jobs within the industry at any point in time, but we are all industry professionals.

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Observations and Reflections on Healthcare Financial Careers

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Over the course of one's career, much can be learned by experiencing different points of view. To be successful, you need to keep your skills sharp and maintain a balanced perspective, including all of the areas in the healthcare industry pie and the evolution of the sub-industries and influencers of the healthcare marketplace swirl.

Thinking Through Likes and Dislikes

As you evaluate your experiences, review your past positions in terms of what you liked most and least, and consider the accomplishments of which you are most proud versus the least proud. With regards to likes and dislikes, everything counts to some degree.

Consider how important various job aspects are to you, such as:

- Stimulating people – upside and downside
- Inside the organization
- Customers
- Advisors
- Commute
- Facilities – luxurious versus bare minimum – how much do you really care?

- Experiences to be gained
- Hard skills
- Soft skills
- Operations versus strategy role – or a blend?
- Ability to problem solve and project manage
- Repetitive nature of work – comfort in knowing your place every day versus enjoying ambiguity
- Positive boss/mentor versus negative boss/mentor
- Strong board versus weak board
- Ability to influence and improve either of the previous two items

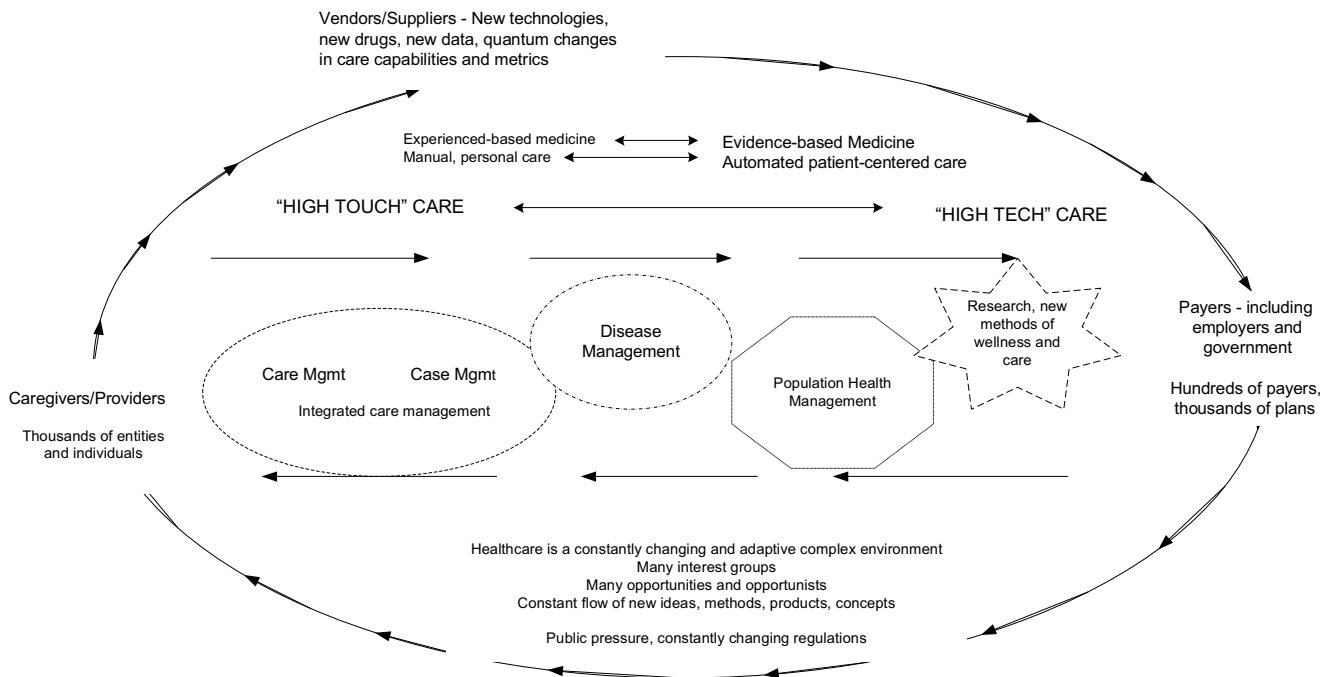
Filling in the Gaps

Regardless of your career stage, there are probably some situations and challenges you would still like to experience. If they are not on the horizon in your current position, it may be appropriate to look for new opportunities. There are plenty of options, so determine your risk tolerance when considering a move. Remember to consider the risk of staying put with limited exposure versus the risk of jumping out of your comfort zone into new parts of the industry and/or new roles.

If you have confidence in yourself, you will grow from each new (good, bad or ugly) experience. Likewise, as a leader, coach and mentor within your organization, ensure that you encourage the people you manage to take appropriate risks with an eye to long-term career growth, well-rounded industry knowledge, hard and soft skill development, and satisfaction from accomplishments.

Linda Klute is a National Healthcare Practice Leader for Tatum, LLC. She can be reached at Linda.Klute@TatumLLC.com.

Exhibit III - Healthcare Marketplace
A complex adaptive environment with many moving parts and many different businesses, continuously influencing each other



Source: Linda Klute, inspired by Crossing the Quality Chasm: A New HealthSystem for the 21st Century, Committee on Quality of Health Care in America, Institute of Medicine, Appendix B



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"The Anatomy of a Market Meltdown" (continued from page 1)

in the bond insurance market, (2) the current state of the insured auction and insured variable rate demand bond markets, and (3) some of the key options and issues facing healthcare borrowers affected by the current market crisis.

The Bond Insurers Take a Hit

The "AAA" (or formerly "AAA" for some) bond insurers most active in the healthcare sector are AMBAC, Assured Guaranty (AGC), CIFG, FGIC, FSA, and MBIA, which together insure in excess of 50% of outstanding municipal bonds. Radian Asset Assurance (Radian), which is rated "AA," is also active in the healthcare sector and has insured bonds for borrowers in the lower "A" and "BBB" rated segments of the market.

Traditionally, the "AAA" bond insurers have focused on insuring fixed rate, auction rate and variable rate demand bonds issued by a range of higher rated municipal borrowers (typically "A" category and above), including state and local governments, healthcare orga-

nizations and others. To be sure, bond insurance provided predictable revenues (based on the annuity stream from policy underwriting) and enviable margins.

In the roughly two year period leading up to the second quarter of 2007 a combination of low interest rates, increasing use by borrowers of derivative-based fixed rate structures, tight credit spreads for fixed rate bonds and increasing investor demand decreased the economic advantage of bond insurance. As such, insurance that was being utilized was primarily in the auction rate and insured variable rate markets with much less fixed rate insurance being underwritten. Facing this market dynamic, a number of the bond insurers expanded into other markets, including insuring mortgage-backed securities, in an effort to increase underwriting volumes and revenues.

As events in the sub-prime market began to take shape in the first and second quarters of 2007, the three rating agencies – Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch) – indicat-

ed their intent to evaluate bond insurer exposure to the deteriorating sub-prime mortgage market and run "stress test" models, which evaluate insurer capital adequacy under worst case default scenarios. In the end, press coverage and rating agency communications have revealed that some bond insurers are more at risk than others.

To date, FSA and Assured Guaranty appear to have weathered the storm; however, one or more of the rating agencies have taken action on a number of the bond insurers over the past six months citing concerns about capital adequacy and sub-prime exposure. The following table highlights the current ratings of the monoline municipal bond insurers most active in the healthcare sector.

So what is next for the bond insurers? MBIA recently raised over \$2.6 billion from the issuance of equity and surplus noted; however, it is unclear whether this may have been enough to satisfy the rating agencies. CIFG was recapitalized through an ownership transfer to two major French banks, but was

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recently downgraded from “AAA/Aaa” to “A-“ by Fitch, “A1” by Moody’s and “A+” by S&P. AMBAC is “evaluating” a number of options after being recently downgraded to “AA” by Fitch, including potentially separating its municipal business from the rest of the operations, and time will tell if a \$1.5 billion recapitalization completed on March 7th will diminish its ratings uncertainty. FGIC’s situation appears most dire of all with its ratings downgraded to the lower investment grade category by Fitch and Moody’s and to sub-investment grade in the case of S&P. Exploratory talks are also underway regarding a potential bailout syndicate to be formed by a number of major financial institutions, and a number of state insurance commissioners have begun to weigh in with hearings and less-than-appealing options for the bond insurers. Finally, Warren Buffet’s Berkshire Hathaway has formed a new municipal insurance entity that looks poised to take advantage of the disarray in the bond insurance market.

In the end, the continued uncertainty regarding a number of the bond insurers has only heightened the anxiety and malaise prevailing in the municipal credit markets.

The Death Nell for Auction Rate Securities

The first auction rate issue was brought to market in 1984 by Goldman Sachs and since that time, the auction rate market has grown to over \$350 billion. A range of corporate and municipal borrowers have utilized auction rate securities to lower their overall cost of capital and shift the “put” or liquidity risk to investors by eliminating bank credit facility renewal risk. High net worth and corporate investors, on the other hand, viewed auction rate bonds as an opportunity to generate incremental yield relative to that which was offered by traditional money market funds.

Virtually all outstanding auction rate securities are insured by the monoline bond insurers and it is this linkage to the bond insurers, many

of which are experiencing heightened ratings pressures and downgrades, which has led to the rapid decline and current state of dysfunction that characterizes the auction rate market.

Unlike the variable rate demand bond market, investors in auction rate securities do not have the explicit right to “put” or sell their bonds back to the broker/dealer, whose job entails making a market by matching buyers and sellers and through a Dutch auction process, determine a yield that “clears” the market of available bonds. A “failed auction” occurs when there are more sellers than buyers or there is no rate that clears the market of available bonds and, as such, the yield is automatically set at a much higher penalty or maximum rate. Ultimately, the pillars of the auction rate market are the liquidity provided by the broker/dealers and the strength of the financial guarantees provided by the municipal bond insurers. Recently, as many healthcare and other municipal borrowers have come to realize, these pillars have begun to crumble and

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“The bond insurance market is in a state of disarray not seen since its birth in the early 1970’s”

some might say - have already fallen.

To give you an idea of the current state of the auction rate market, a Bloomberg article from March 5, 2008 noted the following statistics. From 1984 to 2006, there were 13 failed auctions. In the last two quarters of 2007, there were 31 failed auctions. In the first two weeks of January of 2008, there were 32 failed auctions. On March 4, 2008, there were 521 failed auctions and the trend continues today with, on average, upwards of 60% of auctions failing each week.

Bond insurer rating pressures and downgrades have caused traditional auction rate investors to shun the market and some broker/dealers, who are the same financial institutions facing capital challenges due to their sub-prime exposure, are electing to not support auction rate programs leading to increasing numbers of failed auctions. In the end, the question among auction rate market participants is not whether the market will correct itself; it is how long it will take to unwind completely.

Flu Strikes the Insured Variable Rate Market

Insured variable rate demand bonds, along with those backed by letters of credit, are typically sold to institutional money mar-

ket funds and unlike auction rate bonds, these investors have the right to sell their bonds back to a remarketing agent who makes a market and finds new investors for the bonds. Bond insurance guarantees the payment of principal and interest and a standby bond purchase agreement issued by a commercial bank provides liquidity support in the event of a failed remarketing.

Under normalized market conditions, remarketing agents have typically purchased into their own inventory any unremarketed bonds rather than tender them to the bank providing standby bond purchase agreements. This would cause the interest rate to increase to a much higher penalty rate, which would cause angst for the borrower/client. In the current market environment, however, many remarketing agents are finding it increasingly difficult to continue to make active markets in insured variable rate bonds and inventory unsold balances. In contrast, the non-insured (i.e., letter of credit-backed) variable rate market is “open for business” and functioning normally.

Standby bond purchase agreements typically allow the commercial bank providers to terminate their commitment to pur-

chase unremarketed bonds without notice if the bond insurer were downgraded below investment grade or, in some cases, higher thresholds. In this situation, investors are left in a very undesirable and very illiquid position.

The recent and ongoing bond insurer challenges have heightened investors’ fear that this heretofore unlikely scenario might actually occur and lead to an exodus from variable rate bonds backed by insurers perceived to be at risk. As a result, interest rates for insured variable rate bonds guaranteed by “at risk” insurers have increased dramatically along with liquidity challenges for remarketing agents.

Options and Issues Abound

Borrowers with exposure to the auction rate and insured variable

rate markets have seen their interest costs increase dramatically. In some extreme cases failed auctions have triggered penalty rates that are 15-20%, compared to the 3-5% issuers had been accustomed to. While this has been painful in the near-term, a continuation of the current situation could begin to affect the borrowers’ underlying ratings, which is the least desirable outcome.

As borrowers evaluate the range of potential alternatives to lower their interest costs and market risk, two key factors will likely be central to the cost / benefit analysis; specifically, the likelihood of regaining the value of the bond insurance purchased upfront at the time of issuance and the latitude afforded by a borrower’s particular bond indenture that might allow for a less costly and more timely solution.

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As noted above, four of the six municipal bond insurers most active in the healthcare sector have either been downgraded by one or more rating agencies, or are facing ongoing ratings uncertainty. And these actions have shaken investor and borrower confidence in the bond insurance market to the core.

It is undoubtedly difficult for many borrowers to contemplate walking away from the expensive upfront premium and the insurer guarantee; doing so would require the borrower to write-off the unamortized bond insurance premium and potentially all of the costs of issuance from the original issue, which would directly impact the balance sheet. However, it is also difficult to envision a return to normalcy in the near-term in light of recent and ongoing events. Borrowers must carefully evaluate, as part of their broader decision-making process, the likelihood that an “at risk” bond insurer to which they have exposure might be “rehabilitated” in an acceptable timeframe.

The flexibility provided in a borrower’s bond indenture will also factor into determining the range of viable alternatives for those exposed to the insured auction and variable rate markets. Recent “state-of-the-art” indentures provide for conversions

among a number of different modes, including fixed, auction, multi-mode (i.e., letter of credit-backed variable, insured variable, multi-year, etc.). With this latitude a borrower has the ability to target opportunities in one or a number of different modes.

In many cases, the timing of executing a conversion could be shorter than a traditional refinancing, however, several mitigating factors might include disclosure requirements, effects on any interest rate swaps that might be tied to the original bonds, potential tax law ramifications, and the availability of required bank credit capacity if converting to a variable rate mode with a stand-by bond purchase agreement or letter of credit.

In contrast, older bond indentures may not have incorporated this flexibility and as such, the borrower may be faced with a choice between refinancing and doing nothing, each of which has its own costs and issues.

Summary

The bond insurance market is in a state of disarray not seen since its birth in the early 1970s, and the ongoing ratings uncertainty has virtually paralyzed the auction rate and insured variable rate markets.

Borrowers with exposure to these markets and any of the “at risk” bond insurers, having seen their interest costs skyrocket, are devoting a considerable amount of management time to identifying and evaluating options to get them out of the affected markets.

In the end, it is important for borrowers seeking solutions to work closely with their investment bankers and/or financial advisors to: (1) lay out the range of options and the associated benefits, costs and issues; (2) evaluate the current and potential future risks associated with the bond insurer(s) to whom they have exposure; and (3) understand the mechanics of their bond documents and the latitude afforded by them.

These are unprecedented and challenging times, to say the least, and our recommendation would be to begin developing strategies if you are exposed to the auction rate and/or insured variable rate markets immediately. The uncertainty in the bond insurance market is far from over, the fixed rate markets are bracing for billions of conversion-related new issue supply, and bank credit capacity may soon become scarcer and more expensive. ☞

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First Illinois HFMA: Annual Meeting
Annual Meeting & Dinner
Thursday, July 17, 2008

Harry Carey's Restaurant, Lombard



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A broad topical article may be 1000-1500 words in length. Shorter, "how-to" or single subject articles of 500-800 words are also welcome. Authors should suggest titles for their articles. Graphs, charts, and tables (**PDF or JPG only**) should be provided when appropriate. Footnotes should be placed at the end of the article. Authors should provide their full names, academic or professional titles, academic degrees, professional credentials, complete addresses, telephone and fax numbers, and e-mail addresses. Manuscripts should be submitted electronically, on computer disk or by e-mail as a Microsoft Word or ASCII document.

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Healthcare Financial Management Association First Illinois Chapter

Chapter Education Calendar 2008

Tuesday, May 6, 2008

CFO Education Program and Golf Outing
Medinah Country Club, Medinah

Friday, May 23, 2008

Annual Chapter Golf Outing
St. Andrew's Golf Club, West Chicago

Thursday, July 17, 2008

Annual Meeting
Harry Carey's Restaurant, Lombard

Friday, September 19, 2008

First Illinois Diamond Anniversary Ball
Medinah Country Club, Medinah

Thursday, October 2, 2008

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The Hyatt Lodge (McDonald's Campus), Oak Brook



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