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SWAP STRATEGIES TO BOLSTER LIQUIDITY

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With long-term swap rates at historic lows, health systems with sizable fixed payer swap portfolios may now be required to post substantial amounts of collateral. Combined with other liquidity draws (in particular equity portfolio losses and operating pressure due to the COVID crisis and loss of electives), the requirement to post collateral poses a potentially serious drain on hospitals' liquidity.

Background

As part of their response to bolster liquidity, many hospitals are looking for potential solutions to minimize their current and/or potential future collateral posting exposure. Ponder has developed a few swap strategies outlined below which may be useful depending on a health system's goals. In particular, the strategies will allow hospitals to bolster liquidity either immediately through collateral posting relief and/or over time by lowering future cash flow. Each of these options can be implemented with current counterparties and/or may require new swap counterparties depending on the preferred strategy.

Strategy Costs & Overview

Simplistically, the optimal solution is the one that minimizes the cost of lowering collateral posting and improving liquidity. In order to assess the different strategies, it is important to understand the cost components that a swap dealer will consider in determining the cost to charge health systems. The two main factors that go into the proposed costs are:

FUNDING COSTS – Cost to the Swap Dealer to Fund the Collateral Relief

A swap with a health system is just one side of the transaction for the bank. Acting solely as an intermediary, the bank has generally entered into offsetting trades. As those trades will require collateral to be posted in a like amount, if the health system doesn't post collateral, the dealer will have to post the collateral itself. For the bank, this is like providing a loan to the hospital and would have a borrowing cost associated with it that the bank would pass along. While the absolute dollar value of the expected collateral posted will drive the cost, this charge can also vary depending on the dealer's cost of funds.

CREDIT CHARGE – Credit Exposure that the Dealer Faces with the Hospital

Essentially the risk that the hospital may not make its payments in the future, this is a function of the hospital's credit quality (i.e. rating). But, given the generally high credit quality of most health systems, it is influenced more by the overall length of the swap (i.e. the likelihood that a health system defaults in the near term is low, but increases over 20, 30 or 40 year swap terms).

The total charge proposed for swap amendments will vary from dealer to dealer as each of them have their own sensitivities to the two components above. For example, Dealer A may have a cheaper cost of funds but may be firm on its position on credit exposure. Conversely, Dealer B can have credit capacity, but have higher cost of funds and thus a higher funding cost. Therefore, finding the optimal strategy may require 'shopping around' to find a different, lower cost, swap counterparty through a novation (or swap transfer); however, first we will review options with a hospital's current swap dealer.

Potential Strategies with the Current Swap Dealer

Considering solutions with the current swap dealer may sometimes be more economical versus involving new dealers, especially if the hospital has a strong relationship with that firm. Options to consider with an existing counterparty include:

1. Increased Threshold

Requesting a collateral threshold increase will most likely be very expensive. This strategy not only takes away collateral that is currently held by the swap dealer that it will need to fund itself, but it also increases an already significant credit exposure of the swap dealer to the hospital. (i.e. a large loan for a long time)

2. Collateral "Holiday"

Hospitals can request to have a temporary threshold increase or "infinite" threshold for a specified period of time. During this period, collateral will be returned. When the "Holiday" period is over, the hospital returns back to the original collateral threshold and may be required to post collateral then. The period can be as short as 3 months to as long as a few years. The longer the "Holiday" period, the more expensive the cost would be. (i.e. a large loan for a short time)

3. Collateral "Cap"

Setting a collateral posting "cap" above what the hospital is currently posting is likely the most cost-efficient route, though it will not return collateral already posted to the dealer. The higher the gap between the collateral already posted and the set "cap", the lower the fee the dealer will charge. This solution is attractive for some hospitals that can handle the current level of collateral posting but cannot bear higher posting requirements. A cap will ensure that they have clarity as to the maximum amount of collateral that they may need to post. However, there is a risk that the MTM never exceeds the cap and the hospital paid for something that was not utilized. (i.e. a smaller loan for a long time)

	FUNDING COST	CREDIT CHARGE
1. Increased Threshold	HIGH	HIGH
2. Collateral "Holiday"	HIGH	MEDIUM TO LOW
3. Collateral "Cap"	LOW	MEDIUM TO LOW

Potential Strategies with New Dealer (via Novation)

Novation to a new dealer is a standard strategy that most hospitals should consider. It may be slightly more cumbersome from a mechanical and legal perspective, but may provide better net results. This strategy is effective as new counterparties may be able to immediately provide collateral relief that a current counterparty cannot for a variety of reasons, with the added benefit that it also provides diversification to mitigate other future potential risks.

1. Full Swap Novation

Novating a full swap is typically the most expensive solution given the negative MTM the new counterparty would be asked to fund, but more importantly the long tenor of the swap. (i.e. a large loan for a long time)

2. Partial Novation (Pro-Rata)

Novating a pro-rata strip of the swap decreases the new MTM exposure that the new swap dealer will need to fund. (i.e. a small loan for a long time)

3. Partial Novation (Front-End)

Novating the first 3-7 years of the swap, where the majority of the negative MTM usually is for fixed payer swaps, provides the lowest cost per dollar of collateral relief due to the shorter credit exposure, and thus credit charge. (i.e. medium loan for a short time)

	FUNDING COST	CREDIT CHARGE
1. Full Swap Novation	HIGH	HIGH
2. Partial Novation (Pro-Rata)	MEDIUM	HIGH
3. Partial Novation (Front-End)	MEDIUM	LOW

These strategies can be further enhanced or optimized by including multiple new dealers when considering potential partners. As noted above, different dealers have different costs which can vary on a weekly if not daily basis. Opening the process to the existing counterparty as well as a variety of others will ensure that the hospital is receiving the best potential solution.

Liquidity Generation Over Time

The same market factor of low rates that has caused collateral posting issues for health systems with existing fixed payors can also provide them with the opportunity for cash flow relief on those same fixed payer swaps. While this won't provide an immediate liquidity benefit, it can provide liquidity relief over the remaining term of the swap by lowering the fixed payor swap payments (to the original maturity). While it may seem counterintuitive that health systems could extend a swap and lower its cost, it is possible because the existing swap rate can be blended with a current swap rate that is generally substantially lower.

Table 1: Example Swap Extension

Factors	Current Swap	Extended Swap
Notional	$100mm (bullet)	$100mm (bullet)
Maturity	2030	2050
PV Sensitivity 1bp	$95,737	$258,077
Pay Rate	3.50%	1.80%
Receive Rate	67% 1mL	67% 1mL
Annual Cash Flow through Original Maturity*	($4.07)	($2.37)
Annual Cash Flow through Original to New Maturity*	Matured	($2.37)

As illustrated above, this strategy will expose health systems to a swap with a longer maturity than they currently have and greater market sensitivity. In effect, this strategy lowers cash flow now in an exchange for an increase in cash flow for the extension period. Thus, it is not a strategy for all systems and may not meet all system's goals. Additionally, the extension exposes the health system to additional MTM and, potentially, collateral posting risk. However, for health systems who have the ability to maintain variable rate debt over a long period of time and who want to lower their borrowing cost at a time when rates are near all-time lows, it can be an effective strategy to both capitalize on low current rates and help build liquidity over time.

Liquidity Improvement Conclusions

As health systems grapple with liquidity pressures, improving liquidity through derivative transactions should be an option to consider. Depending on a system's goals, it can be an effective way to solve a problem but is not be the right solution for all systems. It can provide an immediate benefit to liquidity or allow a system to take advantage of low current rates to build cash over time. However, systems who are interested should understand the cost to mitigate collateral posting has increased, especially in the last few months. Finding the optimal solution or lowest cost will depend on the hospital's specific swap MTM/collateral situation, as well as its current swap dealer(s) exposure and willingness to consider other counterparties.

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