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Healthcare boards face new challenges and risks relating to investment management

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In the face of ongoing financial pressures and legislative uncertainty, healthcare providers and their boards of directors are focusing much time and attention on strategies to adapt to and manage evolving risks. Among the most prominent risks are those related to management of a range of balance sheet and employee retirement asset pools.

Increasingly, providers must employ a broader set of more complex investments to ensure their long-term financial health and meet their returns goals. They must also consider how their investment strategy fits with the organization's overall objectives. Boards are an important resource and partner in this endeavor.

As they seek to understand and manage enterprise-wide risk as it relates to investment management, boards should focus on four areas: 1) how best to manage complex investment programs with limited resources 2) implementing enterprise risk management principles for better decision making 3) incorporating outside investment professionals and 4) creating an integrated system to achieve investing and operating goals.

1) Managing complex investment strategies with limited resources

Investment management for healthcare organizations has become increasingly difficult for virtually everyone involved. Some healthcare providers maintain full-time staff dedicated to managing their investments. Primarily due to cost constraints, however, many others rely on internal staff members such as CFOs and other finance staff. However, these individuals also have other job responsibilities (in addition to monitoring investments), and often struggle to balance a myriad of daily responsibilities with longer term strategic planning.

In many instances there is a volunteer committee tasked with providing investment management oversight and direction. While most committees have varying breadth and depth of expertise, the simple truth is that effectively managing diverse investment pools has become a more difficult task for trustees given the growing number and complexity of investment opportunities.

Even with regular committee meetings, there are often numerous important strategic issues for the committee to focus on in addition to investment performance. A significant challenge is the need to make prompt decisions regarding managers and/or allocation strategies, which is directly impacted by a committee's availability and resource constraints.

To overcome the lack of dedicated internal resources and limited volunteer time, as well as satisfy the need for greater customization and navigate the broad range of managers and strategies, providers are exploring new ways to address their investment programs. Specifically, they are turning to an integrated model that engages outsourced investment managers and an enterprise risk management (ERM) approach.

2) Implementing Enterprise Risk Management (ERM) Principles for Better Decision Making

Enterprise risk management has gained prominence as it becomes clear that the traditional asset-only approach to portfolio decision-making is inadequate in today's challenging environment. Among its shortfalls, an asset-only approach doesn't take into account the correlation among and impact of financial and operational risks across the organization.

The key to long-term success of any investment program is putting the appropriate strategic asset allocations in place, understanding the potential impact of investment performance across the organization's portfolios and ensuring that the investment program supports broader strategic and financial objectives.

Given the operational uncertainties and growing organizational complexity, healthcare providers are embracing an ERM approach, a systematic and strategic process that closely links organizational strategy, operations, finance and treasury. An ERM framework is designed to identify, measure, prioritize, monitor, manage and respond to potential events/risks across an organization.

The need for ERM begins with the fact that most healthcare providers typically have a range of asset pools. In addition to operating (or board-designated) assets, the pools can include funds from endowments, self-insurance, defined benefit and defined contribution plans. Each asset pool has a unique purpose, return objective, risk profile and impact on the organization, which makes the strategic asset allocation for the entire investment program much more complex and important.

Understanding the Four Main Components of Enterprise Risk

Under an ERM model, risk "appetite" – the level of risk a provider is willing to take on in pursuit of their goals - is driven by a clear understanding of risks across the organization.

For healthcare providers, there are four main components of enterprise risk:

A) Unrestricted liquidity provides operating and working capital, has long-term growth expectations, supports strategic objectives, including capital spending and has risks associated with the allocation strategy.

B) Capital structures of many providers are composed of various forms of debt, each of which has its own risk profile and interest rate sensitivity. Debt covenants require providers to consistently meet defined financial performance thresholds or risk a potential default. And rating agency views on capital structure risks will factor into the credit rating and impact a provider's cost of or access to capital.

C) Operations/capital budgeting risks encompass competitive positioning activities and execution of strategic initiatives that drive financial outcomes, including spending needs and Affordable Care Act implementation (which could become even more complex, given the ongoing efforts underway to shift from the Affordable Care Act to another yet undetermined model).
D) Defined benefit plans have an additional set of risks for those that have them. Contribution requirements impact cash flow, and plan funded status will directly impact the balance sheet. In addition, discount rates used to determine benefit obligations, as well as earnings on plan assets, are subject to interest rate sensitivity.

From an enterprise-wide perspective, it's imperative to quantify and understand the impact of these pools or portfolios on broader goals and objectives. The financial profile of health systems can be volatile due to operational variability and high levels of exposure to the capital markets (i.e., capital structure and investments). Profitability and overall stability can also be impacted by variables that are largely out of management's control.

Therefore, it's important to evaluate portfolios based not only on traditional comparisons to a predetermined benchmark or peer group, but also on the impact that portfolio allocation strategies have on important financial and credit metrics (such as days cash on hand, unrestricted cash/debt, debt to capitalization and debt service coverage).

Once the key risk factors are identified and quantified, healthcare providers are in a better position to make decisions regarding the level and types of risk factors they are willing to accept in various asset pools and across the broader strategic allocation. They can also monitor performance relative to objectives at the portfolio level and progress toward goals at the organizational level.

3) Drawing on the expertise and resources of outside investment professionals

Working with outside experts can yield multiple benefits. At a high level, an outsourced investment model allows finance executives and board committees to focus on the strategic asset allocation and also makes the overall investment management process more efficient and nimble.

Four Questions to Ask When Choosing an Outside Investment Partner
1. Does the partner have experience with organizations similar to yours?
2. Do they have expertise in a broad range of investments and investment structures?
3. Can they work with you to develop a broader enterprise risk management framework and an integrated investment plan?
4. Who will be on your team and what are their credentials?

Outsourcing investment management to highly qualified professionals provides a number of potential benefits. One is the sheer number of experts with diverse specialties and experience who bring their deep knowledge to the organization. They can also perform time-consuming but critical due diligence on managers and strategies. Further, they can give organizations access to money managers or asset classes that might be otherwise unavailable due to minimum investment thresholds or the length of a particular manager's track record. And in many cases, they can provide the kind of holistic, ERM-based analysis that supports more informed allocation decision making.

Outside experts are generally flexible in how they work with clients and organizations can choose the level of outsourcing that works best for them. For example, they may choose to retain certain money managers and the outside investment manager can provide fiduciary oversight and ongoing monitoring.

4) Creating an integrated system to achieve investing and operating goals

To increase the likelihood of success, healthcare providers should consider finding ways to integrate internal and external resources. In the most common current model, ERM and outside investment-management consultants are often treated as separate, independent entities. In an outsourced model, integrating and treating these functions as co-dependent, however, is one of the better ways to ensure more informed investment decisions that support an organization's long-term financial health.

One way to initiate a coordinated effort is to "change the conversation" by moving beyond returns. While returns are unquestionably an important measurement of success, a holistic approach focuses on returns in the context of overall organizational risk tolerances and broader financial goals and objectives.

How Strong is Your Enterprise Risk Management System? Five Questions to Ask at Your Next Board Meeting
1. Has your board governance determined the organizational risk tolerance and if so, how often do you reevaluate it?
2. Do you have a clear understanding of the range of financial and capital market risks your organization may be exposed to?
3. Is your asset allocation decision-making focused on total return or based on how the allocation strategy supports/impacts financial and strategic objectives?
4. How often has your organization changed its strategic asset allocation and what were the key decision points driving the change?
5. Do you spend more meeting time evaluating/monitoring individual manager performance or discussing strategic allocation and its role in broader strategic goals and objectives?

For example, if a health system wanted to grow liquidity or provide funding for particular capital expenditures, in an outsourced model the investment manager might use specialized modeling tools to develop a suggested investment implementation that would strive to help the organization attain those particular goals while also achieving its desired investment return.

Once an investment program is implemented, the outsourced investment manager monitors its impact on the organization's key financial metrics and credit profile and makes proactive recommendations based on changes in investment markets or the organization's evolving condition or needs. Integrating ERM and outside resources can result in better outcomes than either in isolation.

The Changing Role of Boards

As the landscape for healthcare providers has changed and risks have evolved, some boards are taking a fresh approach to investment-management decisions. Given the realities of limited time, resources and expertise of internal finance teams – as well as constantly changing risks - they are advocating for an integrated, coordinated approach.

By deploying this strategy, healthcare providers and their boards can help ensure the financial success of their organizations and continue their important mission of bringing quality healthcare to their communities. ■