The Power of Strong Financial Risk Management in Healthcare Organizations

Bank of America Merrill Lynch

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As healthcare moves away from a fee-for-service payment environment to one that encourages reimbursement for quality and value, chief financial officers face a damning reality: Revenue and income will be strained as hospitals make a push to keep patients out of their four walls when necessary.

This type of seismic shift naturally exposes any organization to increased risks. For hospitals and health systems, how will they be able to offer high-quality care with fewer dollars? How can they make investments for the future with restrained capital? How can they retain a diligent, hardworking staff as expenses rise? What if another economic collapse like 2008 occurs and decimates the investment portfolio?

Risk management has become one of the most important issues of the day for healthcare providers, and CFOs sit in the hot seat. In an exclusive roundtable, five hospital and health system CFOs and two healthcare finance experts discuss the challenges and solutions around risk management, how trends like consolidation and health IT spending fit in and how other finance executives should manage risks in their balance sheets and portfolios today.

The participants included: Joe Guarracino, Senior Vice President and CFO of The Brooklyn (N.Y.) Hospital Center; Mark Johnson, Senior Vice President and CFO of UnityPoint Health in West Des Moines, Iowa; Ronald Knaus, Senior Vice President and CFO of Spectrum Health in Grand Rapids, Mich.; Dan Moncher, Executive Vice President and CFO of Firelands Regional Medical Center in Sandusky, Ohio; John Orsini, Executive Vice President and CFO of Cadence Health in Winfield, Ill.; Kerri Schroeder, Senior Vice President and Specialized Industries Credit Products Executive at Bank of America Merrill Lynch; and Steve Campisi, Director of Institutional Thought Leadership at U.S. Trust.

The essence of risk management in healthcare

When asked what risk management meant for their hospitals and health systems, the CFOs agreed on several core components. Risk management solutions for providers today must involve an enterprise-wide effort, not just a priority in the C-suite, they said. For instance, Mr. Guarracino said his organization engages and educates physicians to create a culture that will lead to the best possible outcomes. "We're trying to engage our clini-

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cians to be partners in this," he said.

In addition, risk management must factor in the organization's overarching goals of care quality, patient safety and patient/employee satisfaction.

The term "risk" was also defined in several ways. When it comes to the balance sheets, the panelists all agreed several metrics best encompass risk for hospitals: days cash on hand, debt-to-capitalization, debt service coverage, funded status of the pension plan, risk-based capital. On a broader level, risk also permeates financial executives' day-to-day tasks.

> **"The biggest risk is more operational and cultural than the balance sheet..."**
>
> John Orsini, Executive Vice President and CFO of Cadence Health

"Our clients are managing risk that are multidimensional: They have to manage strategic risk, which is having the ability to respond to changes in the external environment, whether those challenges are regulatory or competitive, market risks that might impact the balance sheet," Ms. Schroeder of Bank of America Merrill Lynch said. "It's also operational risk, including the alignment of objectives with physicians and having internal processes, people and systems to manage all of the operational aspects of the hospital."

Consolidation: Why integration is key

Hospital mergers and acquisitions have undoubtedly been on the rise in healthcare since 2009, and these transactions bring their own sets of risks. Mr. Orsini, who is working through a merger between Cadence and Northwestern Memorial HealthCare in Chicago, said financial issues are generally ironed out during the evaluation process. But cultural issues take more time and nuance to handle. Therefore, he advised the leaders of hospitals and health systems going through mergers to ensure their management teams share the same culture and agree on strategies and tactics.

"The biggest risk is more operational and cultural than the balance sheet," Mr. Orsini said. "The balance sheet is fairly static, and you know what the balance sheets are going to look like. You do your financial due diligence and forward-looking conditions, so you can model to expect what the balance sheets are, and what the synergistic opportunities are. The bigger issue in a merger is how you approach the integration work."

Mr. Knaus has also been involved with M&A activity at Spectrum. Last year, the system acquired two hospitals — Mecosta County Medical Center in Big Rapids, Mich., and Ludington (Mich.) Hospital. The two hospitals were very different: MCMC was a county-owned hospital with a weak balance sheet, while Ludington had a more solid financial foundation. As health systems continue to grow, knowing how the next hospital will fit into the portfolio is essential, he said.

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"In both cases, it's a lot of work to integrate the organizations," Mr. Knaus said. "One is an hour away, and the other is an hour and a half away. So we just have to look at the balance sheet that

is coming in and their financial performance."

In addition, different types of transactions bring about different risks for all parties involved. "Consolidation in healthcare is taking place in a variety of models today, from the more informal affiliations to full-on mergers and the creation integrated health systems," Ms. Schroeder said. "The complexity and risk of the transaction increases along that continuum."

However, hospital and health system leaders can advance their overall goals through transactions, given that they keep their objectives in mind, Mr. Campisi said. "It's a lot of flux, but it's an opportunity," he said. "It's the opportunity to see it as an opportunity."

The rise of new capital spending initiatives

Expansions and new construction projects are less common today for hospitals and health systems, as their strategies shift away from large inpatient hubs to more community health facilities. However, health IT — specifically electronic health records — continue to absorb a higher share of capital dollars, meaning the appetite for new projects is still there. The key to tackling the risks surrounding today's capital spending involves thorough evaluation, the panelists said.

"We try to make sure we look at every project that comes before the senior management team, especially the significant dollar projects like IT, capital renovations or buildings," Mr. Moncher of Firelands Regional said. "We do an ROI: What's the long-term benefit? Do they enhance patient care? Do they enhance quality? Do they potentially enhance reimbursement? We try to strategically place capital dollars where we're going to get some longer-term benefit."

UnityPoint, Spectrum, Cadence and other multihospital systems often have few problems accessing the capital markets, but smaller, independent organizations have seen some speed bumps as of late.

"It's a challenge for us. Our access to capital is limited," said Mr. Guarracino of The Brooklyn Hospital Center, an independent hospital that predominantly serves low-income patients. "I always joke around: We have to make our investments like we're the Tampa Bay Rays, not like we're the New York Yankees. And I'm a Yankees fan. If you have the wherewithal, you can take a little bit more risk for more return. Unfortunately, we can't do that."

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> **"By being aware, getting up, talking to people in the other parts of the org ..."**
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> Steve Campisi, Director of Institutional Thought Leadership at U.S. Trust

Overall, Mr. Guarracino echoed Mr. Moncher in saying the solution is to invest wisely and be thoughtful in selecting vendors. "We're trying to make sure we choose our partners correctly," he said.

The nuances of today's investments and long-term assets

In 2008, the financial collapse significantly impacted numerous healthcare organizations across the country. Mr. Moncher said Firelands Regional realized some losses because the markets forced the hospital to be in a collateral posting position. Mr.

Orsini was at San Diego-based Scripps Health at the time, and he said the system "had tremendous unrealized losses."

"Our investment committee got very nervous," he said. "It created bit of a schism. There were some [members] that wanted us to liquidate the portfolio and put it in T-bills."

Investment income has since rebounded for most hospitals and health systems, and many panelists said it was a lesson learned in terms of portfolio management. However, as providers manage their investment portfolios today, risks still persist. How should the portfolio be set up? How much should be invested in fixed income versus alternatives and long-only equities?

"Everybody needs safety in the short run, but they also need growth in long run if they're going to achieve their long-term goals, and it's about balancing these needs properly," U.S. Trust's Mr. Campisi said. "After established an adequate position in liquid bonds, having diversification in the growth piece through balanced exposure to both traditional equity and alternatives is important."

Finding financial sustainability

When asked what healthcare CFOs and executives could do to improve their balance sheets in a meaningful and sustainable way, while simultaneously decreasing risks, the panelists proffered several strategies. For organizations looking to build liquidity, low interest rates and favorable market conditions may make long term debt issuance a good strategy if leverage is not a concern. Sale-leasebacks and monetization of non-core assets are also long-term strategies that could result in quick influxes of cash.

"Even though the industry is rapidly changing, some of the old tricks for balance sheet improvements are still out there," Mr. Johnson of UnityPoint said. "This can include refinancing higher interest rate debt or accelerating accounts receivable management. Some healthcare entities have also considered monetizing assets, such as medical office buildings or selling underutilized real estate."

Mr. Campisi said a goal-based approach to investment is the key to success for healthcare finance executives. He also said communicating with people in different parts of the organization to get a clear understanding of the practical, everyday issues they face is important. "That alone would give a different perspective to the finance executives and cause them to do their job in a more holistic, coordinated and effective way," he said.

In the end, finance executives must trust their instincts when it comes to managing risks for their healthcare organizations. CFOs usually do not ascend to their positions by ignoring prudence and or making rash decisions.

"It's important to stay focused. Don't get overwhelmed by trying to tackle everything at once," Mr. Moncher said. "Prioritize where your highest risks are and what's going to have the most immediate potential impact on your organization. Focus on what needs to be done to mitigate that risk before moving on." ■

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