Having an adequate view of an organization’s risk profile is an ever-present concern for businesses of all types. For healthcare organizations, this concern has grown into a major focal point as providers are being hit on all sides by uncertainty: whether healthcare reform, the regulatory landscape, changing demographics, or even liabilities stemming from employee retirement plans. These risks should be viewed from a top down perspective, in aggregate, to evaluate how shifts in the risk profile may affect the business as a whole. We believe Enterprise Risk Management (ERM) is a concept that many healthcare organizations are pursuing as an effective method to strategically and comprehensively evaluate risk. We prefer this definition of ERM:

“Enterprise Risk Management (ERM) is a structured analytical process that focuses on identifying and eliminating the financial impact and volatility of a portfolio of risks rather than on risk avoidance alone. ERM utilizes a process or framework for assessing, evaluating, and measuring all of an organization’s risks.”

This framework described by the American Society for Healthcare Risk Management can help a healthcare organization to manage its balance sheet, both assets and liabilities. The standard asset-only or liability-only “siloded” approach fails to quantify potential correlations across the risk spectrum that could in turn impact the entire organization and its goals.

For healthcare organizations, proper evaluation of these risks can help them to maintain credit rating, stabilize days cash on hand (DCOH) and comply with debt covenants of their respective credit providers – pivotal metrics in achieving steady operations. A reliable DCOH level, as well as a stable credit rating, allows an organization to borrow competitively and can help to reduce the costs associated with borrowing. The increased liquidity for the organization can also contribute full circle to the holistic stability of the credit rating. In our opinion, proper attention to these three factors can help an organization prepare in the short term to achieve growth over the long term.

**So how do healthcare organizations look at ERM?**

We define five components of enterprise risk: unrestricted liquidity, capital structure, operations, capital budgeting risks, and defined benefit plans. Taken in aggregate, these five components can significantly influence the credit rating and overall financial health of a healthcare organization. Proper management
of these risks can lead to financially healthy organizations, while, conversely, mismanagement of these risks can lead to an unnecessary strain on operations.

When it comes to managing liability portfolios in the healthcare industry, standard practice consists of evaluating finance alternatives based upon a comparison of cost of capital followed by an assessment of the risk of each product alternative. This standard focuses on the liability side of the balance sheet, without necessarily considering the effect that assets have on the fluctuation of said liabilities.

**How does PNC Healthcare measure enterprise risk?**

Within PNC Healthcare, and somewhat contrary to standard practice, we believe in defining the components of enterprise risk as a portfolio of liabilities. For this purpose, risk is bucketed into two categories, interest rate risk and liquidity risk. Interest rate risk covers the gamut of the general level of interest rates, basis risk

2 and tax risk. Liquidity risk measures the put risk associated with debt products and mark-to-market risk associated with interest rate swaps, especially with regard to the potential to reduce DCOH.

Once these risks have been defined and measured, the next step in the assessment is to stress test the liabilities and their potential negative impact (in adverse scenarios) on a healthcare system’s balance sheet and income statement. The components of the operations that can be evaluated with respect to these risks include:

1. Financial assets on and off (pensions) balance sheet
2. System operating cash flow
3. Major capital investments or acquisitions

From an investment perspective, the goal is to measure and determine the impact of changes to asset allocation and liability portfolio composition on organizational risk. A model should take a holistic view of the balance sheet and income statement such that you can manage risk (measured as probability of maintaining credit ratings or other user-defined metrics) by adjusting the levers of asset allocation, liability portfolio, and major capital projects.

**What steps can be taken to mitigate the impact and volatility of enterprise risk?**

Each healthcare organization has a different risk profile with its unique circumstances. Here we would like to provide a couple of examples of how existing healthcare organizations took steps to mitigate the impact and volatility of their enterprise risks.

**Case Study 1:**

Recently, a large healthcare system was faced with a deteriorating operating environment. Because of this, the healthcare system decided to migrate some of its “risk” balance sheet investments to a more conservative, short-duration fixed income portfolio to ensure that the system had adequate liquidity to manage its cash flow and operational needs. This helped improve the healthcare system’s DCOH metric and mitigate the effect the deteriorating operating environment had on its credit rating stability. The healthcare system is also evaluating a liability-driven investment strategy for its defined benefit pension plan, which will help mitigate the variability of the liability.

**Case Study 2:**

A large regional system wanted to increase the impact that its longer-term investment portfolio had on ability to fund strategic operations. The system maintained adequate liquidity through a large position in US Treasury and Agency securities. As a result, it decided to fund a private investments portfolio to ensure that the operating assets pool was generating additional “utility,” in the form of incremental return, to support these strategic initiatives. In this case, the chief concern of the system was related to shortfall risk, in that it did not want the returns on its assets to fall short of being able to fund these expenditures.
Conclusion

Incorporating both sides of the balance sheet can be essential to properly managing a healthcare organizations enterprise risk in a holistic manner. Furthermore, doing so can help to maintain a level credit rating, stabilize DCOH, and comply with debt covenants. By performing an ERM analysis, a healthcare system can calibrate its investment portfolio to help ensure that it is optimized relative to its liabilities. Over the near term, this can help to provide continuity of operations; over the long term, we believe that this can help to fuel organizational growth.

For more information, please contact your Investment Advisor.

FINANCE

“Linking Finance Strategy and Execution in Healthcare,” by Jay Spence

This paper by Jay Spence makes the argument that “As industry reform and increased competitive pressures continue to squeeze already tight operating margins, the ability to effectively define, communicate and align the organization around strategy is becoming a business imperative. The author posits that as strategic plans are increasingly based on anticipated financial impact, “the role of Finance is quickly evolving from a back-office function to a more strategic advisory role.”

The paper then shifts the focus to enterprise performance management (EPM), broadly defined as “a broad set of integrated financial planning and performance monitoring processes, including multi-year financial forecasting, capital planning, detailed budgeting, financial reporting, managerial reporting, and increasingly cost accounting.” The author recommends that, in order to enable “more agile and responsive EPM,” this broad set of functions should be integrated in a single platform.

The paper concludes, “as industry reform continues to evolve, more is being asked of Finance professionals than ever before.” In light of this change, the author recommends that Finance shifts “away from traditional IT-centric or hard-wired applications and embrace more agile planning models designed to grow and evolve as planning needs change.”

Our View

We are increasingly finding ourselves in a fluid, dynamic regulatory environment. In order to compete effectively, healthcare systems will likely need to adopt Finance solutions that are able to evolve with the industry.

Combining enterprise performance management with enterprise risk management can help healthcare systems to make sound strategic plans, maintain liquidity and help to minimize credit rating volatility.

- This paper by Jay Spence makes the argument that industry reform and competitive pressures are necessitating that healthcare organizations focus on strategic planning.
- The author recommends that organizations integrate the various parts of their enterprise performance management into a single platform to facilitate a “more agile and responsive” system.

Link: Axiom – Linking Finance Strategy and Execution in Healthcare
“Hospital Merger Mania Continues throughout the Country,”
by Ilene MacDonald

This article by Ilene MacDonald covers the year to date merger and acquisition activity for hospitals. According to the author, “hospital mergers and acquisitions were off to a strong start in the first quarter of 2017, and recent announcements show no letup of merger mania in the first couple of months of the second quarter.”

The article cites the recent joint venture between University of Kansas Health Systems and Ardent Health Services to run St. Francis Hospital (in Topeka), the Memphis-based Baptist Memorial Health Care finalizing a merger Mississippi Baptist Health Systems, and JFK Health in New Jersey announcing a merger with Hackensack Meridian Health as examples of this trend. It also mentions that South Nassau Communities Hospital “is in talks with Mount Sinai Health System for a potential partnership” and that Cedars-Sinai and Torrance Memorial in Los Angeles announced plans “to formerly affiliate in order to strengthen both organizations ability to serve the community and to enhance access, coordination, and quality of care for the public.”

The author posits that the trend is related to the fact that hospitals are looking to cut costs, improve quality, and expand their service offerings. She cites Anu Singh, managing director at Kaufman Hall, as predicting an uptick in larger organizations being involved in more transactions in 2017 as they look for strategic opportunities to “ensure the continued growth and success of their organizations amongst disruptive forces, including innovative competitors, declining payments, flat or decreasing inpatient volumes, and increasing price sensitivities among consumers.”

Our View

In light of potential regulatory reform and changing demographics in the United States, we expect the strong trend in mergers and acquisitions to continue into 2018.

As financing can be necessary to fund acquisitions, we expect a continued and even increased focus on enterprise risk management for healthcare systems looking to make acquisitions.

- This article by Ilene MacDonald tracks year to date merger and acquisition activity for healthcare systems.
- The article notes a continued uptick in activity in the hospital space, and predicts the trend to extend to large organizations in the near future.
- The reasons cited for the increased merger and acquisition activity include cutting costs, improving quality, and expanding service offerings.

Link: FierceHealthcare – Hospital Merger Mania continues...
The Compass

A guide to help you navigate the institutional investment industry

ABOUT US

The Healthcare National Practice Group

The Healthcare National Practice Group works with U.S. healthcare organizations ranging from community hospitals to those that rank among the nation's largest healthcare systems. Our dedicated approach to the healthcare industry focuses on improving client outcomes by aligning each organization's business issues and unique set of risks across each asset pool. We embrace the complexity of how each of these pools impact the broader goals of the firm and offer strategies to help clients meet their cost of capital and spending needs.

For more information, please contact Patrick Sartor at 502-581-3052 or patrick.sartor@pnc.com.

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2. "Basis risk in finance is the risk associated with imperfect hedging. It arises because of the difference between the price of the asset to be hedged and the price of the asset serving as the hedge, or because of a mismatch between the expiration date of the hedge asset and the actual selling date of the asset.”
   Source: https://en.wikipedia.org/wiki/Basis_risk

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