10 PRIORITIES FOR INVESTMENT COMMITTEES AT NON-PROFIT HEALTH CARE INSTITUTIONS IN 2014

JANUARY 2014

The beginning of a new calendar year is a time many investment committees at non-profit health care institutions review their endowment investment strategy, evaluate what worked and what didn’t in the previous year, and discuss potential changes. That process has never been more important, given changes in the health care landscape.

“This is a time of particular challenge in which health care institutions are navigating transformation in the delivery of care and how it is compensated, along with the requirements of health care reform legislation (PPACA),” said Mike Ancell, partner and senior consultant at Mercer. “Many institutions are dealing with soft patient volumes, adjusting to the trend toward outpatient care, and receiving lower reimbursements. In response, many institutions have engaged in M&A, considered other strategic steps to ensure competitiveness, and have had to make difficult management decisions.”

“Mercer’s dedicated health care investment consulting practice partners with health care institutions to integrate investment strategy with operating and financial objectives,” Mr. Ancell noted. Mercer has identified ten priorities for investment committees to consider:

1. **Assess whether risk tolerance in the investment portfolio has changed, given a challenging operating environment**
   Not-for-profit health care organizations will remain on Moody’s Investors Service negative outlook for the sixth consecutive year in 2014 because numerous pressures continue to weigh on the industry. Evaluate the strategic asset allocation of operating pools (and other obligated portfolios) to minimize the risk of breaching debt covenants in the event of a severe market decline. Ensure adequate portfolio liquidity to accommodate unexpected capital demands. This has added importance for disproportionate share (DSH) providers facing Medicaid reimbursement cuts.

2. **Review the fixed income allocation in both a low and a rising interest rate environment**
   Health care operating portfolios have generally been structured more conservatively than traditional endowment portfolios with larger allocations to fixed income. Operating revenue shortfalls may increase reliance on operating portfolio returns; however, historically low fixed income yields present a challenge. In addition to assuring that overall allocations are appropriate to support an operating portfolio’s multiple objectives, organizations should determine if the size and composition of fixed income holdings remain appropriate and understand their sensitivity to a rising rate environment.

3. **Consider whether a delegated investment approach could offer time and cost savings for your organization**
   Transformation in the delivery of care, coupled with existing operating pressures, requires health care organizations to reduce costs while increasing the quality of care. Delegating certain elements of an organization’s investment function can potentially reduce investment expenses and free-up staff and committee time to focus on strategy.
4. Evaluate whether investment strategy should take into account a pending or potential strategic action such as a merger, acquisition or joint venture
Many not-for-profit health systems are currently engaged in or considering strategic action such as a merger, acquisition, operating agreement or joint venture. Some of these actions may materially alter an organization’s balance sheet and boards may be unwilling to tolerate a significant asset decline post-action. Finance/investment committees should consider whether these factors may necessitate a change in investment risk profile.

5. In a post-merger situation, conduct an investment policy survey to facilitate successful integration of investment assets
The combination of organizations (and their corresponding committees) warrants revisiting key investment policy questions such as time horizon, risk tolerance and return objectives for the new combined entity. Mercer has prepared a survey designed to facilitate this process.

6. Develop a strategy for getting a defined benefit pension plan fully funded
The recent increase in interest rates highlights the importance of developing a roadmap to de-risk a plan as funded status improves. This may include allocation adjustments based upon preset triggers, plan design changes, fixed income composition changes, and risk transfer methods. Be ready to act if the market opportunity is right.

7. Recognize the growing importance of the defined contribution pension plan
The trend away from DB plans elevates the need to assure that an organization’s DC plan is optimized to attract and retain talent. This includes an assessment of investment structure, fees, target date line-up, incentives for participation, communication strategy, and options for managing through retirement.

8. Consider how best to meet the fiduciary obligations of DC plan governance
Recent regulatory attention has focused on DC plan fees and is likely to expand to other areas. Boards may wish to reconsider which area of an organization is best equipped to ensure regulatory compliance and recognize that ultimate fiduciary duty resides within the organization, not its plan recordkeeper.

9. If you are considering moving a captive insurance company offshore, understand the governance, reporting and regulatory requirements
Moving captive insurance companies offshore can result in improved operating flexibility and more beneficial tax treatment. However, there are numerous items to consider, including: captive governance and role of the board, withholdings treatment of US vs. offshore-domiciled funds, preferred country of domicile for the captive, and how to transition funds offshore.

10. Assess the balance sheet implications of taking on capitation or insurance risk
Health care providers with adequate size and capital may have the desire to take on capitation or insurance risk. Doing so may require adjustments in the organization’s balance sheet if capitlated risk becomes a significant portion of revenue. In addition, preserving the financial flexibility to execute such a business plan may become a new investment objective.