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Boldness in Governance

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What's Inside:

At first blush, the idea of "bold governance" would seem like an oxymoron given the current healthcare environment. But the term is actually a perfect descriptor of what is needed today to navigate the numerous challenges facing healthcare organizations.

The word "boldness" can conjure up a variety of meanings. Of course, we all think of people that we would describe as having too much or too little boldness. Most people would equate boldness with willingness to take risk, often irresponsibly. But boldness can also mean that an individual or organization is acting innovatively, being a visionary, or it can infer that one acts with confidence or courage and not brazenness, as some would expect. So, in this case, boldness does not mean one is careless but rather it describes an organization facing its issues and moving with strong convictions and intentional action. Therefore, "bold governance" is the perfect descriptor of what is needed in healthcare today.

It should not be surprising to anyone that given the scale of unprecedented changes over the last several years, starting with a worldwide pandemic, resulting workforce shortages, the intense financial impacts of these rising costs for staffing and inflation, revenue pressures, and investment losses, that the role of governance could significantly change. While the majority of principles that mark good governance still remain, it is reasonable to expect that the present environment will alter certain routine governance practices.

Governance traditionally has been focused on strategic issues rather than day-to-day operations. But bolder governance requires a break from the status quo in terms of the governance model and its past thinking. With the need that some may have for deeper insight into the day-to-day operations, it also requires discussions about the governance and leadership team needed today and for the future. With this change in board oversight, one would expect changes to the management and board dynamics.

Given the need and desire to change the board's role, this article highlights several key questions that boards and management teams should focus on together.

Is our purpose clear to all? Bold governance requires that boards are in lockstep with the values and purpose of the organization. In addition to the basics of good governance (e.g., oversight, policymaking), today's challenges would suggest boards undertake a renewed focus on clarity of purpose, strategic direction, and the requisite clarity of leadership skills required. Boldness in governance requires clear, agreed-upon priorities. It requires boards to step back and think critically, challenging past assumptions and beliefs, looking fresh at potential options, and most importantly, taking action. Early in my career, I was asked to fill an interim role in a hospital that had just lost their CEO and CFO, was losing a significant amount of money, had no cash, and was in arrears to most of their vendors. My first board meeting had one agenda item: "Priorities to Survive and Strategies Necessary for Our Future." Our purpose was clear and agreed upon by all.

> "Freedom lies in being bold."—Robert Frost

Are we self-aware? Bold governance is about making decisions impacting the future and to do this right it is critical to have a deeper understanding of the organization's strengths and weaknesses. A popular strategic planning exercise called scenario planning can help boards understand how various future scenarios can positively or adversely affect their organizations. In David Renz's article on "Reframing Governance" he described the board's role changing in times of crisis from risk management to risk leadership. Risk leadership requires clarity about what is critical to do and what needs to end. The piece that gets hard is to identify what strategies must survive to successfully position an organization for the future. A friend of mine ran a large building materials company that was hit hard in an economic downturn. Focusing intensely on cutting operational costs, she commented that her mistake was that she had cut so much that when things began to recover, they had no strategic initiatives to help them thrive. While we all understand the need to cut costs, bold governance also requires a critical look at what strategies need to continue.

Are we communicating appropriately? We live in a society with numerous venues for chatter, opinions, and voices to critique boards and management teams. While some can be paralyzed by these voices and wish to ignore them, the need to understand that chatter and strategically respond is more critical than ever. Given the anchor role that many of our hospitals and health systems play in our communities, the public attention we receive is expected. Also, many hospitals and health systems are getting an increasing amount of unflattering media attention these days. It's critical to focus on your communication strategy. Considering the public's increasing lack of trust in healthcare, the lobbying against hospitals by some, and the concerns over cutbacks, layoffs, and credit downgrades, an effective plan to communicate with all stakeholders is required.

→ Key Board Takeaways

- Ensure that there is clarity around the organization's purpose, the strategic direction, and the leadership skills needed to accomplish set goals. With this foundation set, the board can take a bolder approach to governance—challenging the status quo and taking a fresh look at board priorities and the organization's path forward.
- Know the organization's strengths and weaknesses. This will allow the board to engage in effective scenario planning exercises and to identify what strategies must survive to successfully position the organization for the future.
- Have a well-thought-out strategy in place to ensure leadership is effectively communicating with all stakeholders.
- Consider how heightened board engagement has impacted the board/management dynamic at your organization. Would it be beneficial to revisit the role and authority of the board versus management, communication expectations, and levels of responsibility related to agreed-upon goals?

Is there a need for heightened board engagement? Given the lasting impact of COVID, workforce shortages, inflation, revenue pressures, and subsequent financial and operational challenges, changes in the information needs of boards should be expected. It should have been anticipated that boards will require a heightened level of engagement not only in their traditional responsibilities but also increased interest in management's actions. Although care should be exercised on how far involvement in management's work goes to make sure the line between management and governance is respected. As discussed more below, the board and management should have a thoughtful discussion about what is appropriate. For example, a board concerned about finances may ask for some increased information and metrics to fulfill its fiduciary duties, but agreement should be reached as to the extent of the info requested and the duration of how long it will be provided. Also, an interesting outcome of our new "virtual" world is that it is easier and acceptable to use these platforms to engage and allows boards to think about recruiting new board members with necessary skill sets outside their traditional service area.

How does increased engagement impact the board/management dynamic? With the tremendous changes and pressures over the last three years, both management and the board should be aware of the impact that increased engagement can have on the traditional board and management dynamic. It is not surprising that when an organization finds itself in a crisis, the line between board and management responsibilities can begin to blur. Facing challenges that few have experienced in their lifetime requires honest discussion about roles, the capabilities of the board and management, and the need to clarify lines of authority in decision making, specific information needs, communication expectations, agreed-upon goals, and short- and long-term metrics.

Robert Frost was quoted saying "Freedom lies in being bold." And today, bold governance offers boards the opportunity to clarify the hospital or health system's critical organizational and strategic priorities, to dive deeper into selected operational areas, to consider alternatives previously not considered, and to thoughtfully think about the board and management needs for today and the future.

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The Benefits and Risks Associated with Remaining Independent

By **Dave Morlock**, Managing Director, *Cain Brothers*

The last year brought numerous changes and challenges for healthcare organizations: dramatic operating and investment market losses; deteriorating balance sheets; higher interest rates and tightening credit markets; staffing shortages; Optum, Walgreens, and CVS competing for physicians and ambulatory care business; Medicare Advantage growth; payer consolidation; recession fears; lingering COVID; unprecedented C-suite turnover; and depressed patient volumes.

Could the future possibly be more difficult for hospitals and health systems than the year 2022? Unfortunately, the long-term answer is likely yes. Especially for hospitals and health systems that lack meaningful scale in both the patient care and managed care sides of the world.

Many people still say, "Healthcare is local." But is it, really? The business of healthcare is certainly not local. It is regional. And the regions are getting bigger. That's why we have seen Advocate Health Care, Atrium Health, Aurora Health Care, and Wake Forest Baptist Medical Center come together as one, as well as Spectrum Health and Beaumont Health and Intermountain Healthcare and SCL Health. Plus, deals are currently pending for Sanford Health and Fairview Health Services and UnityPoint Health and Presbyterian Healthcare Services.

There is a race for scale going on. But not the old-fashioned version of scale that focuses on supply chain, revenue cycle, back office, and number of beds. The new version seeks to achieve scale in attributed lives, as well as "economies of capabilities." By that, I mean capabilities in managing care, physician analytics, and consumerism. Hence the phrase "meaningful scale in both the patient care and managed care sides of the world."

To position for the future, your hospital or health system must be a relevant player in a relevant market. You need both elements to survive for the long haul.

→ Key Board Takeaways

- Your healthcare organization must be a relevant player in a relevant market. You need both elements to survive for the long haul.
- Maintaining long-term access to high-quality care is the key goal of the board. Sometimes local control facilitates that access to care, and other times giving up local control by merging into a larger entity will facilitate that access to care. But "local control" itself should not be the goal.
- There are many benefits to maintaining local control, and there are many benefits to merging with someone else. You should rigorously and objectively assess all of the options when making these decisions.
- Board members should consider that what they think of as "control" is often illusory. There are a number of essential elements of a hospital or health system's success that are not readily controlled by the board or management team. And sometimes being part of a larger organization actually gives you more control over those issues, not less.

Assessing the Benefits of Remaining Independent versus Merging with a Partner

All of this turmoil and transformation is leading boards and C-suites to ask the questions, "Should we seek a merger partner?" and "Can we remain independent?" For hospital and health system governing boards, the decision on those questions may be the biggest decision you ever make on behalf of the organization. To facilitate the discussions on these issues, you need objective unbiased analysis, rigorous assessment of facts, and significant debate regarding all your options. That includes laying out the pros and cons of both remaining independent as well as merging with a partner.

Each organization is different, and circumstances are often fluid. But an initial listing of benefits and considerations is a good way to begin separating the underlying signal from the noise of certain fluid circumstances.

The benefits of remaining independent include:

- Ultimate responsibility for mission, vision, values, and culture of the hospital or health system remains local

- Final governance, strategic, and budgetary decisions remain local
- Decision making takes place "closer to the ground"
- Fewer layers of bureaucracy

On the other hand, the benefits of merging into something larger include:

- Greater regional market essentiality with payers and purchasers of healthcare
- Improved access to capital
- Heightened sustainability (i.e., a bigger boat for choppy seas)
- Access to capabilities and expertise that are currently out of reach (value-based care and physician infrastructure, clinical and business analytics, IT, etc.)
- Enhanced ability to recruit physicians and staff
- Increased political influence
- Broader C-suite succession planning options
- Geographic and payer diversification
- Ability to refer patients to other care settings without "losing them" to another system
- Back-office efficiencies

Oftentimes, the opposite or loss of the benefits of independence become "the cons" in the analysis. It speaks to the trade-off inherent in the analysis. In other words, the loss of ultimate responsibility for mission and culture is a trade-off for greater market essentiality and access to capital.

> If you elect to pursue a potential merger with a larger organization, a clear-eyed assessment of their mission, vision, values, and culture is critical to the long-term success of such a merger. Without appropriate cultural alignment between the merging organizations, you may be headed into a potentially disheartening situation for your local stakeholders.

Of the benefits of remaining independent, arguably the most important issue is local control of the mission and culture of the healthcare organization. It is common for the hospital or health system to reflect the community's culture as a whole. So, if you elect to pursue a potential merger with a larger organization, a clear-eyed assessment of their mission, vision, values, and culture is critical to the long-term success of such a merger. Without appropriate cultural alignment between the merging organizations, you may be headed into a potentially disheartening situation for your local stakeholders.

Consideration of partnership opportunities comes back to the trade-offs. If your hospital or health system is financially strained enough, long-term independence may be quite unlikely. In that case, sacrificing culture may be necessary simply to maintain the existence of access to care for your community. This is especially true for hospitals and health systems located in a place where there are few legitimate merger options.

One thing that you will notice is that "local control" in and of itself is not a benefit of independence. It should not be thought of as your objective. We have heard many boards suggest that local control is one of their key goals. We would argue that ensuring access to high-quality healthcare for your community is the key goal. Sometimes local control can facilitate that access to care, and many other times, merging into larger entities is what can ensure that access to care. But in neither case should "local control" itself be the goal.

When you examine who has the responsibility for essential elements of health system success, you will find that local control is arguably illusory. That means that the board and local management team have less control over critical elements of the business than you actually think. For example, wage rates, Medicare and Medicaid payment rates, inflation, credit market conditions, etc. are largely out of your control. In some markets where there is a single dominant commercial payer, that lack of control even applies to commercial payment rates.

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To be sure, you can have some influence on a number of those factors. But the idea that local boards and management teams are "calling all of the shots" is a bit of a stretch. And sometimes, merging into larger organizations, and giving up some local control, can actually give you more influence on some of those factors.

Boards must wrestle with the question: Should we remain independent? You have a fiduciary responsibility to ask, think about, and answer that question. The discussions on this issue may be emotional. But you must undertake objective unbiased analysis to ensure the best outcome for your community. You need rigorous assessment of facts and open debate regarding all your options. Longer-term access to high-quality care for your community members depends on it.

The Governance Institute thanks Dave Morlock, Managing Director, Head of Health Systems Group, Cain Brothers, for contributing this article. He can be reached at dmorlock@cainbrothers.com. Cain Brothers, a division of KeyBanc Capital Markets, is a trade name of KeyBanc Capital Markets, Inc. Member FINRA/SIPC. This article is for general information purposes only and does not consider the specific investment objectives, financial situation, and particular needs of any individual person or entity.

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Modernizing Aging Infrastructure Can Test Boards' Resolve to Make Difficult Decisions

By **Jeff Hoffman**, Partner, **David Nienhueser**, Senior Manager, and **Matt Perkins**, Manager,
ECG Management Consultants

There are announcements every week about health systems spending nine- to 10-figure budgets on replacement facilities, new bed towers, and large ambulatory developments. Yet for every billion-dollar project reported, there are many hospitals and health systems struggling to commit to basic capital improvements of aging and outdated facilities. So, how do boards of directors replace and expand aging infrastructure in a low-margin, capital-constrained environment with negligible prospects for long-term revenue growth?

There are many pertinent reasons why health systems are delaying major capital improvements and space modernization, often for facilities originally designed and built half a century earlier:

- Minimal operating margins—many hospitals are operating in the red following the pandemic and currently due to staffing costs
- Increased staff spending (20 to 30 percent higher), without corresponding payer reimbursement increases
- Highly competitive market dynamics that minimize the opportunity for volume and revenue growth once the health system must pay for the added interest and depreciation on facility developments

But ignoring capital improvements indefinitely means ignoring the negative strategic implications. This article highlights the impact of delaying modernization of facilities and some of the tough questions and decisions boards will face as they work to create the best care environment for their communities.

Asking Hard Questions

Asking whether capital improvements are necessary is not the most pressing question for executive leadership. Most leaders look at their health system and say, "Yes, we need these capital improvements to modernize and expand." The real questions are:

- How long can we continue to compete with outdated inpatient facilities as our patients get increasingly sick and complex to care for and without non-distributed off-campus ambulatory facilities?
- How can we afford the capital at today's interest rates and in our organization's diminished operating margin situation?
- After we finish our new infrastructure build replacing and modernizing old infrastructure, without strong revenue growth post, how do we manage the significant new interest and depreciation on our income statement?

You may not like the answers. But further delaying modernization of facilities and equipment can put health systems into a long, slow tailspin that is hard to pull up from. The longer organizations go without modernizing, updating, and growing, the greater the chance of credit rating declines, market share losses, and more trouble recruiting new physicians and staff.

Additionally, there are significant short- and long-term impacts of not keeping care environments to a modern, competitive standard:

- **Higher cost per square foot:** Older and outdated facilities typically cost more to operate due to inefficiencies in design and infrastructure, as well as higher routine maintenance costs.
- **Excess inefficient staffing:** Staffing old infrastructure designed and built for healthcare delivery 40 to 50 years ago can drive higher FTE usage and high-cost staff deployed below their highest capability.
- **Cascading failures:** Older facilities usually run on original or dated mechanical systems that are less efficient, harder to repair, and prone to causing catastrophic failures when they go down. When repairs and updates are required, the health system can face code deficiencies that hinder real fixes to the problem.
- **Competitive declines:** Newer facilities, both hospitals and ambulatory, attract patients, physicians, and staff. A truism in healthcare is that new facilities and expansions gain market share at the expense of older facilities.
- **Code compliance:** Not meeting code and/or regulatory agency minimums may force wasteful infrastructure investment.
- **Major medical equipment costs:** Inflation, supply chain issues, and service fees are compounding cost increases in major medical equipment.

The Right Choices Are Rarely Easy

Spending capital comes with tough choices:

- Target investment only in specific clinical services and facilities that increase revenue and market share. Other programs can grow in phase two after success in the initial investment.
- Charge management to become brutally efficient and increase facility productivity in all existing services, in all ways (e.g., reduce staff, reduce length of stay, adhere to the letter of payer contracts and pre-approvals, maximize operational throughput and efficiency everywhere, optimize ambulatory space and clinics).
- Discontinue selected non-performing services, especially financially draining services. Focus board mission support to a narrower range of select clinical services.

→ Key Board Takeaways

- Most organizations are challenged with aging patient care facilities. It's not a question of whether upgrades and renovations are needed, but how to afford the capital given financial constraints and compounding challenges (e.g., staffing, reimbursement, patient complexity) that are shrinking margins.
- Hard decisions are required. Many community-based boards struggle to reduce and target services in their communities. Doing nothing or delaying the decision has direct negative impacts on the organization's credit rating, balance sheet, ability to recruit staff and physicians, and patient satisfaction.
- Leadership and boards must be strategic in their decision. Significant facility spending or upgrades without a sound strategy to positively impact reimbursement and complement service line strategies may not be effective.
- When approving a major capital spend for replacing infrastructure, boards must require executive leadership to present a plan for how the organization will accommodate the interest and depreciation expense on the income statement once the new facility opens—a combination of growth, efficiency, and program elimination.

Board members will always struggle with these difficult decisions noted above, but they must be made—it's the only way to pay for new capital investments. Failure to do so can lead to further health system decline; and eventually, some other board or leadership will make those tough decisions. What's best for your organization will ultimately be informed by the situation, geography, scale, and how bold the top tiers of leadership are willing to be to make the really hard decisions.

Below are examples of solutions that board members must consider:

- **Partner and/or consolidate:** Merge (through acquiring or being acquired) with another organization in the region, or a larger entity from outside of your region. But that's just the beginning—take a critical look at what the combined entity offers and be prepared to consolidate duplicative services. Scale alone isn't enough; efficiencies must be achieved as well.
- **Narrow the mission:** Many hospitals have become all things healthcare to their communities and provide a broad range of important services that require yearly support. Boards justify this as part of the organization's mission. But with today's lower growth trend, increased competition, and more challenging reimbursement environment, it is time to focus your mission support. Other community resources must step in and assist. This can be done by outsourcing select services or eliminating a service—a particular challenge for smaller hospitals, where the board is close with the community. Examine which services are difficult/expensive to staff, have a low or negative margin, are low volume, or are done better by another organization nearby. Shift the perspective back on the core mission of acute healthcare for your community.
- **Migrate to lower-cost settings:** Moving services from the hospital to ambulatory locations can reduce operating costs and often comes with a lower capital requirement than hospital construction projects. A thorough strategy is required to ensure that services are not inefficiently duplicated or redundant but doing so thoughtfully can result in a financial win for the system and a better experience for patients. Straying from the main hospital campus can also be an opportunity to add visibility and attract more patients.

All the above will have direct, positive impacts on a declining financial report. Are we advising health systems to spend money they don't have? No. We are saying that modernizing and updating existing facilities and infrastructure in today's world must be done, and it comes with very difficult decisions—and not just about the cost of borrowing. Boards need to focus on how capital is spent, how operations can be more efficient, and how the health system's mission remains focused.

The Need for a Modern Care Environment

It is always hard for a board to approve $300 million or more in capital spending when the organization has dropped from a 6 percent to a 2 percent margin. It's even harder to consider borrowing when the immediate impact is a credit downgrade (and higher overall payback). However, healthcare is an industry where a modern, contemporary environment of care is essential. Inpatient care isn't going away, the growing population is still outpacing the slowly and steadily decreasing inpatient use rate in most regions of the country. On top of that, inpatient care continues to increase in cost and patient complexity. Therefore, it's unlikely that newly built inpatient space will be transitioned to an ambulatory function anytime soon. Additionally, care is still migrating to the ambulatory care environment and the space requirements are growing.

These facts make it particularly important that when the decision is made to renovate or construct a new facility, it needs a modern strategic design with flexibility to accommodate the unknowns of the future:

- Organizations should opt for more observation beds instead of inpatient beds. These beds have lesser regulatory requirements and therefore cost less to build and operate.
- Limit non-inpatient functions in hospital construction; the administrative suite and outpatient clinics can be constructed elsewhere or in a building adjacent to the hospital at a lower cost per square foot.
- Plan shell space in inpatient buildings sparingly and when it is part of the hospital planning strategy, be sure to position it so that it can accommodate a variety of functions, not just inpatient beds or serve a single future purpose.
- Plan the diagnostic and treatment functions that inpatients require to be easily accessible to outpatients, to optimize the utilization of the assets. This could be achieved by a connection through an adjacent ambulatory building, or via a separate outpatient entrance with close proximity to the diagnostic and treatment areas.

As discussed above, doing nothing has a direct, declining impact on a community health system. We advise organizations to continue to invest in and modernize their healthcare platform. The decision to move forward with a significant ask must include implementation of strategic initiatives ahead of, or alongside, the capital spend.

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