

Financial Management in Health Care Organizations

Week 1

Lecture 3

Chapter 2: Agency Problems & Agency Cost

Objectives

- Define agency relationships and agency cost
- Explain how agency relationships can generate agency cost
- List & explain some common agency relationships that exist in health care settings, and recognize them in health care settings
- Explain the special agency problems that managed care contracts create
- Explain how health care organizations can ameliorate their agency costs

Key Terms

- Agency cost
- Agency problem
- Agency relationship
- Financial engineering
- Hospital revenue bond

Agency Relationships

- An agency relationship exist when one party (agent) acts on behalf of another party (principle)
 - The physician is the agent for the patient
 - An insurance carrier is the agent for the patient

Agency Relationships

- An agency relationship exist when any party can pursue his/her own interest while contractually obligated to represent the interest of another.

Agency Problems

- At any point an agency relationship exist, there is the opportunity for the agent to act in his own self interest
 - Regardless of whether the opportunity is acted upon, the opportunity is referred to as an agency problem
 - For example, a physician who orders a test with no diagnostic value but for which she will collect a fee

Agency Cost

- Agency costs are losses associated with agency problems
 - Loss in market value (or health status)
 - The physician orders a test with no diagnostic value, loss in the patient's wealth (being unmatched by any gain in the patient's health) is an agency cost to the patient

Types of Agency Problems

- Economic and financial theorist have identified five types of agency problems.

First Agency Problem

- The first type of agency problem exist when the agent takes advantage of their situation to enjoy excessive perquisites at the expense of the principle.
 - Cadillac versus Chevrolet
 - Agency supplies for personnel use
 - EMS examples?

First Agency Problem

- The first type of problem usually occurs when the agent's behavior is difficult to monitor
 - Many health care organizations are uniquely predisposed to this type of problem
 - Private, not-for profit there may be no one with incentive to monitor administrator's use of resources

Second Agency Problem

- The second class of problems involve situations where equity holders take on projects that are "too risky".
 - This is related to the option theory
 - Equity holders have option to buy (a call option) the full value of the firm from lenders.
 - The option can be exercised by paying off the face value of the firms' outstanding debt.

Second Agency Problem

- The option expires on the day the option matures (the day the outstanding principle and debt are due).
 - Equity holders can increase the values of their shares by undertaking risk in excess of that which the market will reward.
 - Now, because the holders of debt will bear some or part of any losses, it is the firm's bondholders that will endure these agency cost

Second Agency Problem

- WHEW! That was a mouthful!
 - For use “plain English folk”, essentially the second problem comes down to this:
 - If the organization overextends it's financial debt (through borrowing or capital projects) and there is insufficient cash to pay the debt – somebody (shareholders or lenders) are going to suffer the loss!

Third Agency Problem

- The third type of agency problem occurs when stockholders reject potentially profitable investment.
 - Chapter 10 (The Basics of Capital budgeting) will develop the proposition that a potential investment that has a net present value (NPV) greater than zero should be assumed.

Third Agency Problem

- Organizations heavily in debt are often reluctant to assume further risk (stockholders reject potentially profitable investments).
 - Generally speaking, bondholders (not shareholders) will gain a share of the increase in value from an investment.
 - Because shareholders all the gain from investments, some profitable projects will be ignored.

Fourth Agency Problem

- Bankruptcy!
 - When organizations are in sufficient financial distress to declare bankruptcy some of the claimants (lenders) may demand legal proceedings and liquidation
 - The liquidation process reduces the value of the organization that can be realized by all claimants.

Fifth Agency Problem

- Information asymmetry
 - If managers possess information that others do not, undesirable outcomes are potential
 - Just think of this as “insider trading”
 - Managers may sell securities prior to public knowledge of poor performance (unfavorable profit statements) or in the health care setting – the hospital is involved in a malpractice case and the managers sell their stock in the corporations prior to public notification.

Cost Control & Agency Problems

- Cost control is considered a financial concern, operating decisions actually determine the majority of cost
 - In the hospital environment, one must ask who is responsible for the decision that determine the level of operating cost?
 - Paramedic + EMT-B = \$
 - Paramedic + EMT-I = \$\$
 - Paramedic + Paramedic = \$\$\$

Agency Problems in Health Care Finance

- Agency problems in health care organizations extend beyond cost control.
 - The relationship between the physician & patient
 - The present value of unnecessary services for any given patient is the agency cost to the patient

Agency Problems in Health Care Finance

- The physician is the patient's agent in the selection of hospitals and prescribing hospital services
 - In addition to being an agent for the patient, the physician is also an agent for the hospital in the allocation of its resources
 - The utilization of hospital resources impacts operational cost and profitability

Agency Problems in Health Care Finance

- Managed care has created incentives for physicians to alter or modify behavior to maximize profits in their own practice
 - If the physician is contract to provide care (\$50/mo) there is not much financial incentive to order too many test

Agency Problems in Health Care Finance

- Health plans can also act as both agent and principle
 - Agent to the patient
 - Principle to itself (shareholders)
 - Some believe the competition among health plans will alleviate agency cost
 - Competition must be at a level of choice of the consumer, or that of the employer that is a perfect agent for its' employees

Agency Problems in Health Care Finance

- Hospital management assumes the role of the agent for the equity holders of the hospital
 - Managers have vary degrees of opportunity to consume perquisites at the expense of the organization

Agency Problems in Health Care Finance

- The relationship of the investor-owned organizations carries the possibility of corporate takeover, which can discipline management and prevent over zealous perquisite consumption
 - This relationship is non-existent in not-for-profit organizations

Agency Problems in Health Care Finance

- At certain times, equity holders and managers are agents for bondholders
 - Due to the high debt-to-equity ratios of most health care organizations equity holders possess a strong desire to engage in high risk activities (projects)
 - These high risk projects have the potential of enriching equity and wiping out claims of bondholders

Agency Problems in Health Care Finance

- Financial decisions including capital budgeting and strategic financial management are affected by the relationship of equity holders/managers and bondholders.

Resolving Agency Problems

- One method to resolve agency problems for not-for-profit organizations is to have the agent and principle enter into contractual agreements
 - The contracts are developed in such a manner that incentives for the agent and the principle coincide

Resolving Agency Problems

- In investor-owned organizations deterring agency problems can be accomplished by financial incentives such as:
 - Paying professionals & managers based on performance
 - Profit sharing
 - Partial ownership
 - Inclusion of managers as partners in the practice's net income

Resolving Agency Problems

- Financial engineering (formation of contracts that have unusual cash flow patterns) can reduce some agency problems
 - The intention of financial engineering is to alleviate investors' fears of agency costs and thus reduce the cost of capital to the issuing organization.

Resolving Agency Problems

- One of the first examples of financial engineering is mortgage pass-through securities
 - Investors receive monthly payments against based on receipts of payments against a pool of mortgages

•Resolving Agency Problems

- Recent financial engineering developments include payments to investors based on collections of patient accounts

Resolving Agency Problems

- Hospital in rural areas receive little to no funding from local government
 - The need for capital funding can be addressed by:
 - Local commercial lenders
 - Mortgage financing
 - Municipal bonds
 - Not usually done because the bonds are guaranteed by local governments

Resolving Agency Problems

- Municipalities will generally issue hospital bonds in lieu of general obligation bonds
 - Hospital bonds are guaranteed only by revenues of the hospital
 - Hospital bonds usually carry a high risk (interest rate)

Summary

- Health care organizations have a many diverse agency relationships.
 - Financial agency relationships are complicated by the existence of agency relationships in the market for the service provided.

Summary

- In health care, as with other organizations:
 - Managers are agents of equity holders
 - Equity holders and managers are agents of debt holders (lenders)

Summary

- However, in health care:
 - Physicians and third-party insurance providers are agents for the patients
 - Not only are allied health professionals agents of the organization; they are also agents of the physician in the deliver of health care

Summary

- Additionally, in health care:
 - Managers, as well as trustees, become agents of the physician in the selection of product lines and equipment even though medical staff are not principles of the hospital.

Summary

- Agency relationships increase agency cost, which in turn impacts financial management of the organization
 - External financing requires financial engineering
 - Capital acquisitions decisions are often conditioned by complex interprofessional agency relationships