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ENTERPRISE RISK MANAGEMENT – TIME TO ACT

by Mary Botkin and Ken Felton

THE CALL TO ACTION

The intensifying financial pressures bearing down on the American government and taxpayers because of egregious corporate mismanagement will force increasing and unprecedented scrutiny on the business world. For risk management, we believe a paradigm shift is at hand.

Organizations of every kind will feel pressure to do more than they have in the past to understand the risks they face, to expose and challenge every assumption they make and take steps to quantify and then appropriately mitigate the exposures they uncover. This is not an easy transition. Just as the health care community has struggled over the course of the last 25 years with the paradigm shift from an unsystematic clinical experience to a more analytical, evidence-based approach, the corporate world will have to move from a traditional silo-centric risk management system to a more formalized, analytical, enterprise-wide risk management competency.

Risk management consultants, rating agencies, accounting firms, the Institute of Chartered Accountants, the Risk and Insurance Management Society and other management experts all strongly recommend or require effective enterprise risk management (ERM) programs. The organizations that resist ERM may find their inaction represents a significant risk itself – one for which their leadership may ultimately be culpable. Now is the time to embrace the ERM philosophy, foster a robust ERM culture and develop a strategy to implement ERM at the highest level of your organization.

WHAT WILL TAXPAYERS DEMAND IN RETURN?

As more news comes in about Bernard Madoff and what may be the largest Ponzi scheme in history, some media reports question the "disgraceful negligence" of the American financial regulators who reportedly examined Madoff's investment operation several times over a 20-year period without finding any wrongdoing.[1] How will the American public respond to the global economic meltdown – the real estate collapse, the credit freeze, government bailouts of insurance, banking and automotive companies as well as the Bernard Madoff scandal? What will American taxpayers demand to make sure these things do not occur again?

The current crisis is now largely seen as a failure of risk management.[2] Many observers speculate that the subprime mortgage mess could have been avoided, or at least tempered, had the various financial institutions fully invested in ERM programs.[3] The perceived shortcomings of current risk management focus in this country will push government, regulators and the American taxpayer to insist on more in-depth risk management practices. This means ERM.

More will be expected of risk management, but risk managers can expect to have fewer resources at their disposal. As noted in a recent article in *Business Insurance*, "Shrinking budgets, possible layoffs and continued concern about the financial health of major insurers will make 2009 a challenging year for risk managers." Risk managers may have to defend the value of even basic programs because of the changing business environment and possible budget cuts.

At the same time, organizational risks have increased in complexity due to the changes in the world economy. Organizations and their stakeholders are more keenly aware of the growing number, complexity and variety of risks they face. Furthermore, because of the interaction of these risks, traditional, siloed risk management programs are clearly ill equipped to manage them all; it is just as clear that the trend toward increasing risk complexity will continue.

THE RISKS FACING HEALTH CARE PROVIDERS

Financial risks have certainly grown in the health care environment. Decreased reimbursement, increasing costs for employees, supplies and equipment, care for the uninsured, bad debt and Medicare and Medicaid cuts are some of the more significant exposures facing hospitals today.

To assess the impact of the current economic crisis on hospital performance, the Noblis Center for Health Innovation surveyed 36 hospitals in the last quarter of 2008, and "results suggest that hospitals are clearly feeling the impact of the economic crisis most acutely in two ways – dramatic losses in investment income and difficulty accessing capital."[5]

Quality of care, meanwhile, does not diminish in importance. As the preamble to a research study offered by the American College of Healthcare Executives states, "While financial issues remained the uppermost concern for hospital CEOs in 2007, concerns related to quality and patient safety continue to gain prominence." According to Thomas C. Dolan, CEO of the college, "Creating, implementing and monitoring the systems to improve quality and patient safety has become a major focus of hospital CEOs."[6]

In October of 2008, The Centers for Medicare & Medicaid Services (CMS) implemented a patient safety program that may deny payment for certain conditions CMS has identified as "reasonably preventable" during the hospital stay of a Medicare beneficiary. Referred to as "never events" or "hospital-acquired conditions," they include:

- Pressure ulcers
- Surgical-site infections
- Foreign body left in patient during surgery
- Air embolism

A study of U.S. hospitals found that while most collect information on adverse events, far fewer make effective use of the data.[7] The U.S. has not made widespread or consistent progress in improving the quality of health care since the Institute of Medicine released the *Crossing the Quality Chasm* report in 2001, according to witnesses at a Senate Health, Education, Labor and Pensions Committee hearing January 29. The U.S. ranks last of 19 countries on a measure of mortality amenable to medical care, Commonwealth Fund President Karen Davis told the committee. Five years ago, America was ranked 15.[8]

Sub-standard quality conditions cut across so many departments and functions within hospitals that many experts are now recommending an enterprise-wide risk management response to decrease the number and impact of adverse events. High-profile corporate cases have motivated some organizations to invest significant resources in enterprise risk management. Other organizations remain hesitant, despite the increasing risks.

EXTERNAL DEMANDS FOR REFORM

External pressures are also encouraging and in some cases insisting organizations take greater responsibility for managing risks on an enterprise-wide basis. The boards of many companies are making ERM a key focus of discussion.

In 2006, the Institute of Chartered Accountants in England and Wales delivered their Combined Code of Internal Control Guidance for Directors. This document outlines the ERM responsibilities of directors of publicly traded companies. Principle D. 2 of the code states, “The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.” The document further requires that the company provide an explanation that would enable a shareholder to evaluate how the principles of the code have been applied. Given the magnitude of the current crisis and the culpability of corporate management in the U.S., we can expect the rise of comprehensive requirements, such as those instituted in the U.K., here in the U.S.

In the U.S., Standard and Poor’s (S&P) has been a major proponent of examining ERM in the assigning of credit ratings. S&P also believes that ERM is a key differentiating element in the execution of sound governance and strategic corporate judgment. ERM is seen as the difference between focused, strategic risk taking and stark speculation. In just two years of rating financial institutions, 10% of those investigated enjoyed or suffered rating adjustments as a direct consequence of their ERM review. A mere 13% had ERM practices deemed strong or excellent.

S&P judges ERM success by an organization’s ability to repay its financial obligations. In evaluating ERM focus and process, S&P looks at a number of areas. The primary focus is on assessing the organization’s approach, structure and culture, and the roles and accountabilities of the individuals charged with the implementation of ERM. Does the organization have a clear understanding of what its risk tolerance is, based on an analysis of its portfolio of risks?

S&P also wants to know that the organization is using the ERM process in deciding which risks should be accepted and managed and which should be transferred or avoided if they fall outside of the organization’s risk tolerance. The other area of S&P focus is strategic implementation. S&P evaluates how risks are identified, how metric success is measured, accountabilities assigned and board involvement in the program. The organization’s performance in response to identified risks will be critically evaluated.

MAKING ERM WORK

Better-managed companies tend to have higher credit ratings – and higher ERM competency.[11] Companies that want to go the ERM route will need to start with management. ERM readiness and success is contingent upon senior leadership and board-level commitment.

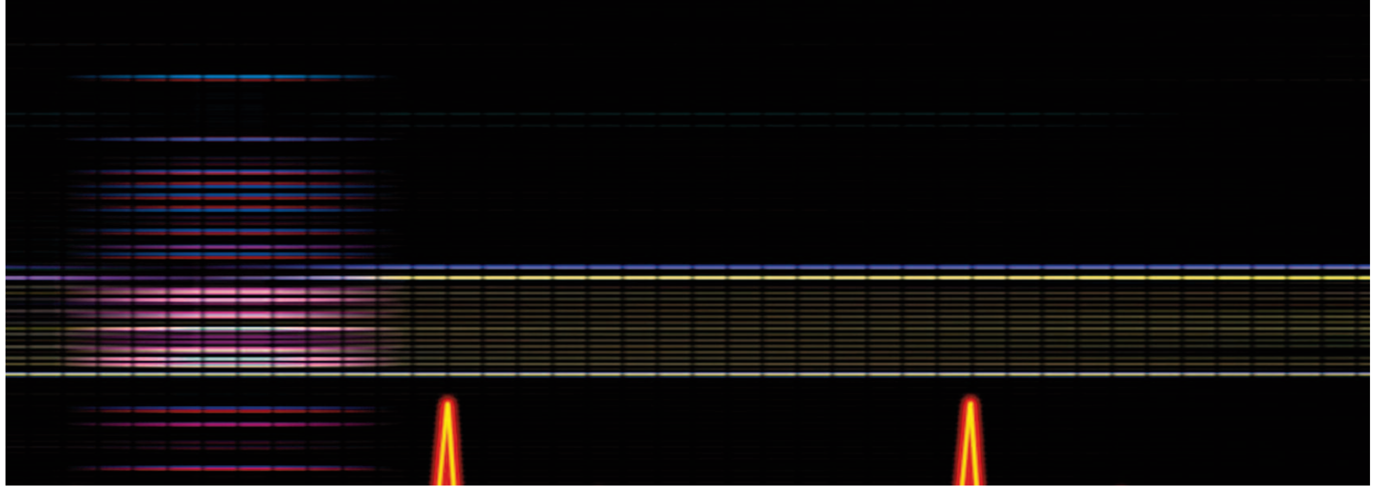
Positioning ERM in the organization must become part of the organization's culture and strategic planning process in order to be effective. That comes from the top. Here are some of the actions that are embedded in the operation of ERM-driven organizations.[12]

- Management drives implementation and maintenance of an ongoing process for identifying and managing significant operational risks.
- Accountabilities and ownership of key risks are clearly assigned.
- Corporate scorecards assess risk and measure against predetermined tolerances.
- Exception reports are produced for all instances where scores/ratios are outside maximum tolerances; reports include detailed plans for remedies.
- The company adjusts its corporate risk profile and risk-management process based on past experience, pro forma model results, stakeholder expectations and market conditions.
- Management reports regularly on risk/return measures used to identify areas where risk tolerances and objectives are not being met.
- Senior management establishes an environment and corporate framework that embeds risk awareness throughout the organization.
- The organization's governance structure recognizes the importance of an integrated risk management approach by placing responsibility for corporatewide risk management with a member(s) of senior management with access to the board.
- The board and senior management receive, and constructively critique, frequent reports on risk metrics and updates on key risk management activities across the entire organization.
- Senior management displays thorough and consistent understanding of key risks and risk mitigation practices across the entire organization.
- The board and senior management clearly define the corporate risk profile – risk tolerance and risk management objectives – that supports overall corporate goals and expectations of key stakeholders.
- The company establishes a separate department to take a holistic view of the company and coordinate risk management activities across the enterprise, led by a member of senior management – a chief risk officer (CRO).
- Business strategy and capital allocation are based on risk-adjusted returns and other risk metrics consistent with the corporate risk profile.

GETTING STARTED

Implementing the list above cannot happen overnight. ERM is complex and demanding, but the following steps will be helpful in your implementation:

- Begin with a clear understanding of your organization's strategic objectives.
- Customize the ERM process so that it fits into your culture.
- Keep the process simple and understandable (there is no right way or wrong way to implement ERM).



- Educate, educate, educate the staff about the process.
- Designate a chief risk officer.
- Develop an oversight committee of senior leadership (e.g., CEO, COO, CFO) to review risk portfolio and controls.
- Define roles and accountabilities for implementation.
- Develop an integrated view of risk – each department must identify, quantify and prioritize what risk mitigation factors are in place for each critical risk.
- The oversight committee then develops the organization's risk profile, determining which risks to accept and manage, and which to transfer or avoid.
- Determine the organization's risk tolerance: set the organization's ERM goals and objectives based on the prioritized risks.
- Assign responsibilities, accountabilities and ownership for each risk with determined metrics for success.
- Metrics must be quantified consistently for effective comparative analysis (of loss frequency and severity and level of controls).
- Evaluate performance metrics for evidence of effectiveness (three times per year by the oversight committee and once a year by the full board).
- Consistently communicate with the staff regarding the program's performance.
- Reassess the ERM organization as necessary to judge success.
- The oversight committee and the board should use performance data in strategic planning and effective resource allocation
- Evaluate how the organization responds to specific risks and make adjustments as required.

THE FUTURE IS HERE

Many believe we are on the verge of an era of increased focus on responsibility. The economic challenges facing the government and taxpayers will certainly pressure the business world to manage their risks so that shareholders will not be penalized by corporate mismanagement. President Obama is demanding more corporate responsibility in light of all of the Troubled Asset Relief Program (TARP) monies that have been used to bail out struggling U.S. corporations. In the near future, demands for full transparency of a company's internal controls and proof of the effectiveness of their ERM programs will increase.

ERM should be woven into an organization's culture and strategic planning. If your organization has not yet accepted the necessity of ERM, evaluate others' experiences. Talk to a qualified risk adviser. Review the range of ERM options and consider the steps you might take in planning, executing and implementing your program. The reestablishment of corporate integrity as well as the survival of the business community may in part depend on the acceptance and successful performance of enterprise risk management.

CONTACTS

For further information, please contact any of the following.

Mary S. Botkin
Practice Leader
Houston, TX
281 584 1646
mary.botkin@willis.com

Ken Felton
Hartford, CT
860 756 7338
kenneth.felton@willis.com

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