

Enterprise Risk Management

(Views of Healthcare, Insurance, and Rating Agencies)

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Introduction of ERM:

“Enterprise risk management is the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the impacts of risk on an organization’s capital and earnings”. Among the most important areas of risk covered in risk management are finance, operations, and strategy.

There are various ERM frameworks which all typically involve identifying risk areas relevant to the organization’s objectives, assessing those risks in terms of likelihood and magnitude of impact, determining a response strategy, and monitoring progress.

Steps Prior to the ERM Framework:

Although a risk management program does not involve a complicated system, some preceding steps have to be taken in order for risk management framework (mentioned above) to work. The most important step is to ensure the infusion of the risk management working culture and risk management awareness among the board members, management, and employees. In order to do the above, the company has to include the risk management cornerstones in its missions and strategic planning. Some of the most commonly recommended compartments of risk management include having a risk management philosophy, risk management policy, risk management roles, risk management awareness, training, and infusion into the working and corporate culture. Once the above steps have been completed, then actual process of risk management framework can be implemented.

ERM can also be described as a risk-based approach to managing an enterprise, integrating the concepts of strategic planning, operations management, and internal control. ERM is evolving, just as more complex organizations are emerging, to address the needs of various stakeholders who want to understand the broad range of risks facing their organizations. Today, regulators and debt rating agencies such as S&P500 have increased their focus on the quality of the risk management process of companies. In other words, regulators and debt rating agencies believe that the quality of risk management in a company says a lot about the riskiness of the company. In other words, a company with a low quality risk management process is more vulnerable and therefore may be more likely default on its debt obligations.

Types of ERM Framework:

There are two mains type of framework for risk management one of which is the Casualty Actuarial Society (CAS) framework and the other is the COSO framework. Each of these frameworks has a different ERM framework. The CAS framework defines ERM as “the discipline by which an organization in any industry assesses, controls, exploits, finances, and monitors risks from all sources for the purpose of increasing the organization’s short and long-term value to its stakeholders.”

CAS framework recognizes the following risk types including hazard risks, financial risks, operational risks, and strategic risks. The CAS framework adopts a different risk management process than does the COSO framework.

CAS ERM Framework:

The CAS framework recognizes four types of risk which are hazard, operational, financial, and strategic risks. In addition, the risk management process used by the CAS framework involves the following steps of establishing the context, identifying risks, analyzing/quantifying risks, integrating risks, assessing/prioritizing risks, treating/exploiting risks, and finally monitoring and reviewing.

COSO ERM Framework:

The COSO ERM framework has eight components. The first step is to analyze the internal environments. The next two steps are to set objectives and to identify potential events. Having identified the events, it is then important to assess the level of risk and then to design an appropriate response for the risk. After designing a risk response, it is important to control, communicate, and monitor the process and the results.

As for the objectives of the COSO ERM framework, managing the risk in business strategy, operations, financial reporting, and compliance are the most important one. As for strategy, the ERM framework must ensure that the high level goals of the company are aligned with supporting the organization's mission. In operations, the ERM's task is to ensure effective and efficient use of resources. In financial reporting, ERM ensures the reliability of operational and financial reporting. Finally, the ERM framework must ensure that all activities of the company are in compliance with applicable laws and regulations.

Objectives of Enterprise Risk Management:

The risk management process helps enterprises protect and create value for their stakeholders, employee, customers, regulators, and society. Every organization has different risk functions to deal with different risks and each risk function has a certain capability and coordinates with other risks functions. The objective of ERM is to ameliorate this capability and coordination. In addition, ERM program should improve the organization's ability to manage risk effectively.

The Important Question:

Considering the fact that all organizations face risks that they cannot reduce or eliminate, which means that they will face the consequential losses corresponding those risks, the crucial question is at what price is it reasonable to eliminate the risk. The correct answer is: in order to maximize returns or minimize losses companies must make sure they invest less than the amount of capital at risk to have a successful risk management or efficient risk management program.

Areas of Risk Management:

Internal Risk & External Risk:

Prior to explaining the areas of risk, it is crucial to note that there are two main directions from which the companies face risk. Companies face risk both from their internal and external environments. The external risk can be economical, natural, political, social, or technological. In other words, the company has no role in creating these risks cannot take any precautions to avoid them. On the other hand, the internal risks derive from within the company and the management can take various measures to avoid, reduce, share, or accept them.

In order to identify internal risks, organizations use controls. These controls also help management monitor and understand how the risk response strategy is working and whether the objectives are being achieved.

Generally smaller companies do not have any controls in place in the beginning. They hire risk auditors to make an assessment and recommend the type and number controls needed. The larger companies who already have internal risk auditors and have many controls in place may also hire risk auditors to improve their risk management. Risk auditors generally make an annual risk assessment of the enterprise and provide recommendations.

Types of Risk & Risk Treatment:

Almost every risk management framework follows the approach of identifying, analyzing, responding to, and monitoring risks and opportunities. These risks and opportunities facing the enterprise can be either internal or external. The first and most important step to risk management is to detect the risk for which the companies use controls. Controls are placed in critical areas where the risk can occur.

Responses to these risks can vary depending on the nature of the risk and the business activities of the enterprise. Avoidance, reduction, sharing, and acceptance are the types of response that are currently being used.

Elimination/Avoidance:

One type of response that many companies choose is avoidance. In other words, many companies simply either decide to abandon areas or activities that lead to the increase in risk or decide to do things differently to remove the risk. This type of response includes putting

measures in place that either stop the threat from occurring or prevent it from having impact on the enterprise and its activities.

Reduction:

Reduction is another response strategy chosen by large companies that have the financial resources to hire risk consultant to help them with risk management. This strategy involves taking measures to control the risk which means to either reduce the likelihood of the risk occurring or reducing the impact of the risk on the enterprise or its projects.

Sharing/Transference:

Sharing or transference is another risk response strategy which is not as common as the others. This strategy involves passing the responsibility of managing the risk to a third party via a contract or a specific clause within the contract.

Acceptance:

Finally, acceptance is another response strategy adopted by certain companies when facing risks. Many companies adopt this response strategy because they do not have the financial capability to do anything about the risk or the risk cannot be mitigated at a reasonable cost or the type of risk that they are facing is new there has not been any solution for it yet or the likelihood and impact of the risk is at a tolerable level.

Challenging ERM Tasks:

There are currently many important challenges to ERM implementation many of which the large corporations have been able to overcome but they still remain a challenge for small size companies. Among those are prioritizing risks within and across functions, establishing

ownership for particular risks and functions, demonstrating the cost-benefit of the risk management effort, and ensuring efficient risk coverage by internal auditors.

As for the large corporations, many have advance risk management programs and have been able to deter threats or minimize the number of risks that they are facing. However, they are still facing the challenge of maintaining efficient risk coverage. In other words, they have minimized the number of risks but they have more controls in place than they need and they now wish to find out what is the least number controls needed to achieve the same results. This is because using too many controls is more costly and reduces efficiency.

IT & Existing Risk/Future Risk:

Most financial executives believe that technology is mainly used to identify existing risk rather than to protect future risk and reducing future risk.

Using IT to Drive Effective Risk Management:

For business owners to embrace the risk management program, it is crucial to simplify and automate the risk management processes. Technology facilitates the incorporation of risk management into critical business processes while improves performance. Therefore, IT can be used to make risk management more effective.

Evolution of Risk Management:

The attitude of business toward risk management has changed significantly over the past decade. Corporations used to view risk management as an option which is nice to have whereas risk management is now an obligation which companies must have. In addition, the ERM now defers from the traditional risk management. Unlike the traditional risk management which was a

reactive approach without involving much communication, ERM is now both proactive and holistic and requires communications between corporate entities. In addition, ERM is financially focused and internally audited.

Views of different industries on ERM:

Every organization that implements ERM defines its own process and implements it differently because the risks and opportunities that companies face vary from each other. In addition, every industry has different view on ERM because the business activities of different industries are variable.

View of Healthcare on ERM (2008):

Recent surveys show that the interest of risk managers in healthcare has grown significantly (from 32% to 57%) over the past few years and they are now extremely receptive of ERM. Among the main reasons for this substantial increase in attention to risk issues in healthcare are the economic pressure facing the industry and the anticipation of major reforms promised in the recent election. The economic pressure is growing because the stress on US healthcare system is increasing and at the same time the government is reducing the medical benefits that it used to provide. In addition, the anticipation of reforms is signal for healthcare because the healthcare system will soon have to cover 45 million new people that are not covered.

As a result of the two recent trends mentioned above, the healthcare industry will face more risks and therefore will need to manage the new risks, which justifies why their interest in ERM programs is increasing.

Example of Risks for Healthcare:

One of the recent trends in healthcare is the drive to shift from paper-based recordkeeping to electronic recordkeeping. This trend uses the cloud computing technology to achieve its goal. Certain areas in healthcare are already using electronic records. For example, certain clinics or hospitals now use electronic prescriptions. However, the shift we are referring to here is going to be at broader scale and globally.

With this new trend come certain risks that need to be managed. In other words, storing and transmitting healthcare records electronically involves significant risks as computer systems are vulnerable to breaches.

View of Energy Sector on ERM:

Energy companies are also among the enterprises whose interest in risk management program has increased significantly. However, the types of risk they face are different from those in healthcare and the level of investment they will be required to make also varies.

"The idea of enterprise risk management (ERM) is an approach to quantify all risks and for oil and gas companies, especially upstream firms in exploration and production, those risks include commodity price fluctuations, production volume variations, political risk around the world, and weather disruptions such as hurricanes."

For example, ERM helps oil companies to discover the risks for which they could buy insurance, but had chosen not to. The most important and significant of those risks is commodity price fluctuations.

View of Insurance Sector on ERM:

After the start of the subprime mortgage mess many industries started thinking about how this mess would have been handled if the various financial institutions fully invested in the ERM program. Evidently, one of the many industries who now deal with the consequences is the insurance industry. As a result the insurance industry has truly embraced ERM and has also become very supportive of the initiative of various rating agencies to incorporate the ERM programs of financial service firms into the overall rating.

Rating Agencies & ERM:

S&P was actually among the early supporters for use of ERM in various industries. S&P itself started to incorporate the quality of companies' ERM in the overall rating in 2005 and the other rating agencies followed the same steps afterwards. "S&P has reported that it has been able to find two specific forms of information from ERM analyses performed thus far. The first type of information is the degree to which a firm has a comprehensive mastery of the risks that they face. The second type of information S&P is able to gain is the extent that the firm's management optimizes revenue for the risks they are willing and able to take."

Rating Agencies & 4 Major Components of ERM analysis:

Risk management culture and governance is one of the ERM components that S&P uses and influences its rating decision. This process measures the importance of risk and risk management in considering daily corporate judgment.

Risk control is another component of the ERM that S&P uses. This process "helps achieve risk control through identifying, measuring, and monitoring risks, setting and enforcing risk limits,

and managing risks to meet those limits through risk avoidance, risk transfer, or other risk management processes.". In addition, S&P risk control focuses on the three main aspects of an organization's risk control practices which are policies, infrastructure, and methodology.

Analysis of emerging risk preparation is also another component of the ERM that S&P uses and it refers to those risks that are either very new or very rare. These risks cannot be managed by the risk control process (above) due to our lack of experience with them.

Finally, analysis of strategic risk management is the "formal process that a firm uses to the ideas of risk, risk management, and return of risk into corporate strategic decision-making process". In other words, this analysis will be able to detect the root of the problems with risk management in any company.

Conclusion:

It is now evident that the importance of ERM has been growing significantly regardless of the company and industry. Many companies have been improving their ERM programs as a reaction to the current financial turmoil and many others had been early adopters of ERM because of the nature of their business. In addition, the recent initiatives taken by the rating companies to include the quality of ERM of the companies into the overall rating, which first started with the financial companies and is expected to be considered for all industries, is the most significant implication about the importance of ERM.

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