Chapter 4

Corporate Risk Management

Where observation is concerned,
chance favours only the prepared mind
Louis Pasteur 1822-1895

Uncertainty is our friend, not our adversary
Pickford, 2001: 9

4.1 Introduction

During most of history, mankind has had no more than gut feel when faced with uncertainty. This, however, changed dramatically in the 1600's when mathematics was applied for the first time in games of chance. The discoveries that followed gave solid foundations to the insurance industry and catalysed the development of the field of risk management. Business could finally make rational assessments and develop suitable plans to manage unacceptable levels of risk (Bernstein, 1998).

The private healthcare industry is focused on providing maximum member benefits whilst safeguarding member funds. To achieve this, the healthcare administration organisation needs to employ a nimble risk management process that will ensure that all significant risks are suitably addressed.

4.2 Aim

This chapter will provide the reader with an understanding of corporate risk management and will show how the field has developed both abroad and in South Africa.

A plausible definition for corporate risk management and appropriate empirical study results will also be presented.

4.3 Beginnings of risk management

4.3.1 Americas and United Kingdom

Risk management appears to be one of a group of management sciences that was greatly influenced by the Second World War. Conducting business activities during this time period required significant efforts in logistics, materials management, strategy and tactics. The explosion of activity in American universities after the war fed upon this trend and resulted in a great leap of interest in the 1940's and 1950's. In this early post war period, many university business schools offered courses and programmes in insurance and actuarial science (Young *et al.*, 2001: 4-12).

The subsequent development of risk management into a recognised field of study could be summarised by the following sequence of events (ibid):

- Corporate insurance buyers began with general responsibilities for the purchasing of property and liability insurance coverages necessary for their respective organisations.
- Due to market pressures, insurance buyers were expected to exert some influence on the risks that they were insuring. As a result, the insurance buyer's activities were extended to include health and safety initiatives and policy and procedure development for core activities.
- Certain industries started foregoing insurance cover and self-insuring certain losses and risks due to a lack of affordable external cover.
- As corporations started becoming aware of risk in its broader sense, there was a slow expansion of risk management principles beyond insurance into a dedicated management science. In 1960, Head, a prominent USA author of the time, made the following statement regarding modern day risk management (Valsamakis *et al.*, 2000: 6-7):

> *"Risk management is a special subdivision of the discipline of general management – a subdivision having the basic goals of preventing accidental losses and financing the restoration of those losses, which cannot be prevented, to enable an organisation to fulfil its mission despite actual or potential losses."*

Risk management in the United Kingdom was also derived from the insurance industry. The formal study of risk management started in the

1970's with many insurance brokers and underwriters of the time being cynical regarding this change in direction. Subsequent development in the field of risk management has seen the establishment of an Institute of Risk Management. More recently, the Institute introduced a three-year, non-degree programme in risk management in 1989 (Valsamakis *et al.*, 2000: 7-8).

4.3.2 Risk management in South Africa

Sources indicate that the acceptance of risk management as an approved field of study took place in the 1970's with the first known risk management statement signed by the Barlow Rand Group (Valsamakis *et al.*, 2000: 8-9).

In 1975, an organisation named the South African Risk Management Association was established. The association was the first attempt in trying to bring together a single body that could promote the furtherance of the new field of risk management in South Africa. The association, however, did not succeed in gaining sufficient momentum and was disbanded in 1979 due to a lack of education regarding modern risk management and a lack of buy-in from the insurance sector (ibid.).

The following current bodies are in existence:

- *The South African Risk and Insurance Management Association:* This body was established in 1986. The aim of the association being the promotion of the professional status of corporate risk and insurance manager.
- *Risk Management Federation:* This is an umbrella body for, and authoritarian voice of, the risk management industry in South Africa.
- *The Society of Risk Managers South Africa:* Inception in 1990, the aim of this society being the professional development of risk management as a managerial function and to coordinate the risk management profession in South Africa.

Many of the tertiary institutions in South Africa provide courses on risk management as part of their undergraduate, postgraduate and MBA programmes (ibid).

4.4 Reasons and benefits of corporate risk management

Many reasons are cited as to why organisations should consider migrating to a fully integrated risk management paradigm known as corporate risk management. Below are some of the most notable reasons:

4.4.1 Results of a 1995 risk management study conducted by Arthur Andersen (Arthur Andersen, 1995):

- Less than 50% of senior executives are satisfied that their existing risk management systems are able to identify and manage all potentially significant risks.
- More than 50% of participants have made recent significant changes to their existing risk management processes.
- Nearly 60% are planning significant changes within the next three years.

4.4.2 Risk management is often perceived to be the responsibility of a select group of individuals within the organisation instead of the duty of all employees. This is specifically true when dealing with assurance functions such as internal audit, fraud management, etc. (De Loach, 2000: 25).

4.4.3 Organisations address certain risk types in isolation and neglect the benefits of netting exposures that offset on an enterprise-wide basis (ibid).

4.4.4 Current risk management programmes are often viewed as a negative science focusing only on the hazardous or downside elements of risk. Entrepreneurs are beginning to realise that managing risk is an effective means of generating sustainable stakeholder value (IFAC, 1999:3).

4.4.5 Until the development of corporate risk management principles, entrepreneurs were unable to see unique risks develop according to a risk continuum. This new approach allows management to identify and evaluate risks across all levels of the business continuum and deliver realistic assessments of such risks on the organisation's value (ibid).

4.4.6 The recently revised corporate governance standards in South Africa call for a more integrated risk management process (King Committee, 2002).

4.4.7 Increased need to provide maximum shareholder value in a fast changing environment (Harrington *et al.*, 1999: 20).

4.4.8 Risk management within the corporate environment is treated very much like an afterthought with many of the existing approaches being fragmented (De Loach, 2000: xii).

4.4.9 An inability to confidently make informed decisions regarding the trade-off between risk and reward due to the increased complexity of risk categories faced by organisations (Valsamakis *et al.*, 2000: 14).

4.4.10 Increased public awareness regarding risk and the organisation's increased responsibility to ensure transparency when conducting activities (Sunter *et al.*, 2002).

4.4.11 New and updated authoritative standards calling for more stringent risk management programmes and disclosure (De Loach, 2000:10).

4.4.12 The reduction of insurance usage as a method of financing risk exposures by organisations. In a comparative study conducted in 1977 the cost of property insurance, for a number of the fortune 500 United

States corporations, comprised 26.3% of "cost of risk". By 1996, this figure had stabilised to 14.1% (Valsamakis *et al.*, 2000: 15).

4.4.13 The increased representation of risk management at board level and the increased responsibility of trustees. (Pickford, 2001: 292).

4.4.14 Outdated risk pricing techniques that do not allow for more accurate measurement of loss or opportunity (ibid.).

The above concerns highlight the need for an advanced risk management programme across all activities within an organisation. Should organisations decide to implement such an initiative, it is generally accepted that the following benefits will arise:

- Management will have comprehensive and accurate information at hand to formulate informed decisions regarding the trade-off between risk and reward in advance (De Loach, 2000:30).
- Company value is maximised by ensuring that new strategic concepts are fully assessed before being executed (ibid.).
- All business resources are aligned with the purpose of evaluating and managing the uncertainties that the enterprise faces as it creates value (ibid.).
- Management will select and implement the best strategy for exploiting desirable risks while concurrently mitigating or eliminating undesirable ones (ibid.).
- Allows better allocation of capital to risk driven initiatives (ibid.).
- Provides certain protection against executive liability and adverse publicity or attention from investor and other stakeholders (IFAC, 1999:10).
- Optimises the integration of assurance activities thereby avoiding duplication of effort.

4.5 Corporate governance requirements

Corporate governance refers to the maintenance of acceptable relationships between the management of an organisation, its board, shareholders and other relevant stakeholders (Valsamakis *et al.*, 2000:74). Another definition refers to corporate governance as holding the balance between economic and social goals and between the individual and communal goals (King Committee, 2002: 5).

Based on international developments in the field of corporate governance, Mervyn King, a former judge, and Geoffrey Bowes published the first South African report on corporate governance in November 1994. This initial report was, however, criticised as not providing comprehensive governance standards for today's complex organisation (Vermeulen, 2000). The revised standard aimed at enhancing previous principles by focusing on the following seven criteria (King Committee, 2002: 9-10):

- *Discipline:* A commitment by all to adhere to recognised and accepted correct behaviour.
- *Transparency:* The ease with which an outsider is able to make meaningful analysis of an organisation's actions and its economic fundamentals.
- *Independence:* The implementation of suitable mechanisms to minimise or avoid the potential of conflicts of interest across a wide range of parties within and external to the organisation.
- *Accountability:* Ensuring that individuals and appointed groups are made fully accountable for their decisions to the extent that investors are able to query and assess the actions of such parties.
- *Responsibility:* Management behaviour that follows internal mechanisms to allow corrective action and the sanctioning of poor management.
- *Fairness:* Ensuring that the rights of various groups are acknowledged and respected at all times.
- *Social Responsibility:* The organisation is perceived as a good corporate citizen that is non-discriminatory, non-exploitive, and responsible with regard to environmental and human rights.

The initial King Report issued in 1994 made no delineation between internal audit and the field of risk management. However, the revised King Report issued in 2002 does make delineation between these key functions. This delineation results in a number of unique risk management responsibilities being assigned to existing key role players within the organisation. These include:

- The chief executive officer
- Board of trustees
- Financial director

In addition to this, a number of new functions are recommended in the revised corporate governance standard, viz. risk management committee and chief risk officer. Table 7.1 included under chapter 7 identifies the responsibilities of the key role players as indicated in the recent King Report on Corporate Governance and also provides additional recommendations from other leading international governance sources.

4.6 Defining corporate risk management

Corporate risk management developed as an extension of the field of risk management (Pickford, 2001: 289).

The first developments relating to risk management were initiated in the late 1980's by a number of global corporations. These corporations' set-up internal divisions whose aim was to minimise financial and human resources provided to the area of insurance management and to outsource insurance affairs to third parties. (Pickford, 2001: 291).

In the mid-1990's the first corporate risk management process was set in motion. Leading international corporates of the time established risk task forces to consolidate all risk management processes and utilise information derived from such efforts as the basis for their strategic and operational decision making (ibid.). Accordingly, the initial purpose of reducing insurance costs as a primary aim of risk management was replaced.

Table 4.1 details the evolution of risk management from a financially focused discipline to an integrated process. The table also includes details on the capabilities, benefits, scope and focus, which should be evident, as the risk management type progresses from a fragmented to fully integrated approach. The following source references were adapted in preparing the summary:

- De Loach, 2000: 24, 176-179
- Watt, 1994.

Table 4.1: Evolution of risk management

Criteria	*Initial*	*Repeatable*	*Defined*	*Managed/Optimising*
	Awareness	***Risk Management***		***Corporate Risk Management***
Capabilities	1. Risk identification	1. Common risk language adopted 2. Dedicated risk management resources 3. Risk management policy 4. Risk drivers identified	1. Uniform risk management process 2. Roles and responsibilities defined 3. Risk management policy followed by all 4. Risk measurement 5. Consistent risk reporting 6. Risk management tolerances initiated	1. Enterprise wide task strategies 2. More objective risk measurement 3. Integrated risk management systems 4. Risk measures integrated with business performance and incentives 5. Continuous feedback
Benefits	1. Risk awareness	1. Improved business knowledge 2. Uncertainties evaluated 3. Risk-reward decisions receive more attention 4. More effective risk-based decision making	1. Risk anticipated better than competitors 2. Linkage between risk management and line operations management 3. Improved capital and resource allocation 4. Risk transparency with stakeholders	1. Capitalise on market opportunities 2. Risk managed as integral part of business management 3. Risks aggregated to reduce risk transfer costs 4. Risk management integrated with business planning strategy

Continued…

Criteria	***Initial***	***Repeatable***	***Defined***	***Managed/Optimising***
	Awareness	***Risk Management***		***Corporate Risk Management***
Methods used	1. Undefined roles and responsibilities 2. Reliance on specific personnel to initiate	1. Common risk language 2. Quality people assigned 3. Defined tasks 4. Initial risk management architecture implemented	1. Process uniformly applied across the firm 2. Rigorous methodologies and processes institutionalised	1. Intensive debate on risk/reward trade-off issues 2. Best practice, continuous benchmarking ongoing 3. Emphasis on exploiting risk
Focus	1. Financial risk	1. Financial and hazard risks and internal controls	1. Risk	1. Risk
Scope	1. Chief Financial Officer	1. Treasury, insurance and operations involved	1. Business managers accountable (fragmented approach)	1. Optimal alignment and integration of resources organisation-wide
Linkage to opportunity	1. Understated	1. Understated	1. Is clearer	1. Seamless integration

The following formalised definitions are found within current literature relating to corporate risk management:

4.6.1 Refers to the total set of interventions in matters as diverse as the construct of the company in terms of its organisational design, the culture designed through its value system that drives organisational behaviour, the ethical climate conveyed by the board and senior management, recruitment criteria, key financial, operational and other processes of the company and the set of metrics that the company has laid down as indicators of good or desired performance (King Committee, 2002: 76).

4.6.2 The process of deciding which risks to avoid, control, transfer or accept (ibid).

4.6.3 Seeking the upside while managing the downside. A company takes risks in order to pursue opportunities to earn returns for its owners; striking a balance between risk and return is key to maximising shareholder wealth. (IFAC, 1999: 6).

4.6.4 The identification and assessment of the combined risks that affect a company's value, and the implementation of a company-wide strategy to manage them (Pickford, 2001:67).

4.6.5 The process of identifying risk, assessing risk and dealing with risk (Academy for Healthcare Management, 1999: 2-4).

4.6.6 A structured and disciplined approach that aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the uncertainties that the enterprise faces as it creates value (De Loach, 2000: 5).

4.6.7 Aimed at protecting the organisation, its people, assets, and profits, against physical and financial consequences of event risk. It involves planning, coordinating and directing the risk control and risk financing activities in the organisation (Valsamakis *et al.*, 2000: 22).

4.6.8 A continuous process and an element of corporate governance. It promotes efficient and effective assessment of risk, increases risk awareness and improves the management of risk throughout the organisation. This includes anticipating and avoiding threats and losses as well as identifying and realising opportunities (De Loach, 2000: 93).

Based on the aforementioned definitions, the following key elements are evident:

- It is a process or total set of interventions;
- involves effective management techniques, including identification and assessment;
- focuses on combined risks encountered throughout the organisation; and
- aims at achieving expected or desired performance.

Based on these key elements the author will utilise the following as an acceptable description of corporate risk management:

“Corporate risk management is the structured process of identification, assessment and the continuous management of the combined risks aimed at ensuring stakeholder expectations are achieved.”

4.7 Corporate risk management in South Africa

As part of this study, a random sample of 80% of medical schemes registered with the Council of Medical Schemes in South Africa was approached regarding corporate risk management. Results from 27% of the registered schemes were received and utilised as the basis for empirical study results presented.

The survey covered the following areas:

- Fundamental concepts in risk management;
- risk identification within the healthcare administration organisation;
- where respondents believed they had progressed to on the risk management continuum;

- whether a uniform risk management process was being utilised and if so, what the key components of such a process were; and
- risk quantification techniques utilised by such organisations.

The survey issued for comment is included under annexure A of this study.

The scales applied in the empirical study were as follows:

Importance	>8 = Crucial…..7…..6 = important…..5…..4…..3 = cognisant…..2….. 1 = unnecessary…..0 = N/A
Organisational Status	>8 = Managed/optimised…..7…..6 = defined…..5…..4….. 3 = repeatable…..2…..1 = initial/rudimentary
Difficulty in Implementing	>8 = Major restructuring required…..7…..6 = six to twelve months management attention needed…..5…..4….. 3 = 1 to 3 months management attention…..2….. 1 = no problems encountered

With respect to the issue of whether revised corporate governance standards have increased the importance of corporate risk management within healthcare organisations, all respondents indicated that revised corporate governance standards had increased the importance of risk management within their organisations. The same organisations reported a 7 on the scale of importance regarding this issue.

Based on information presented in table 4.1, respondents were requested to indicate on which level they believed their respective organisations were on the journey towards corporate risk management.

Figure 4.1: Empirical study results: benefits of corporate risk management

What improved benefits arise from a corporate risk management programme and how are these being addressed within the organisation?

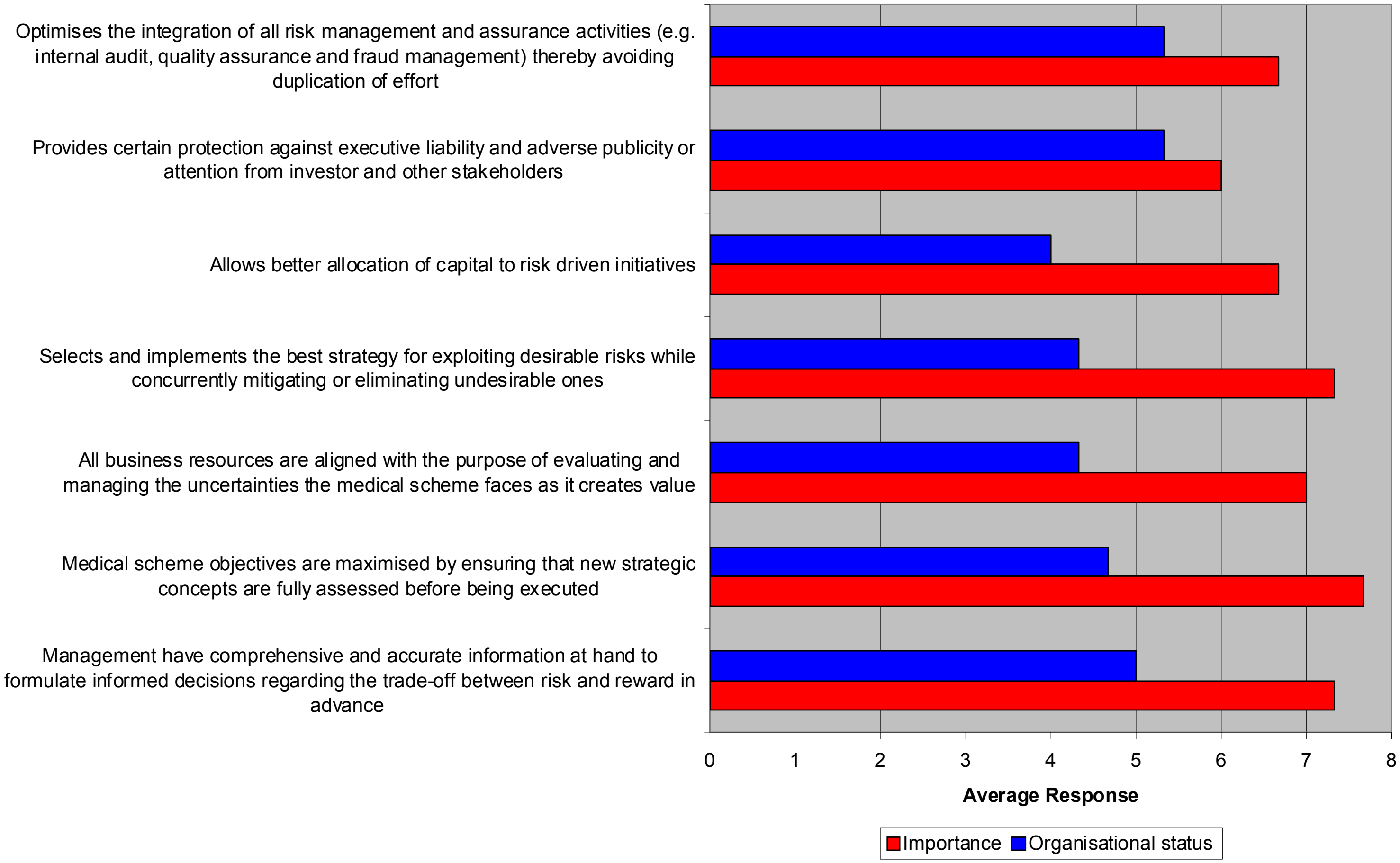
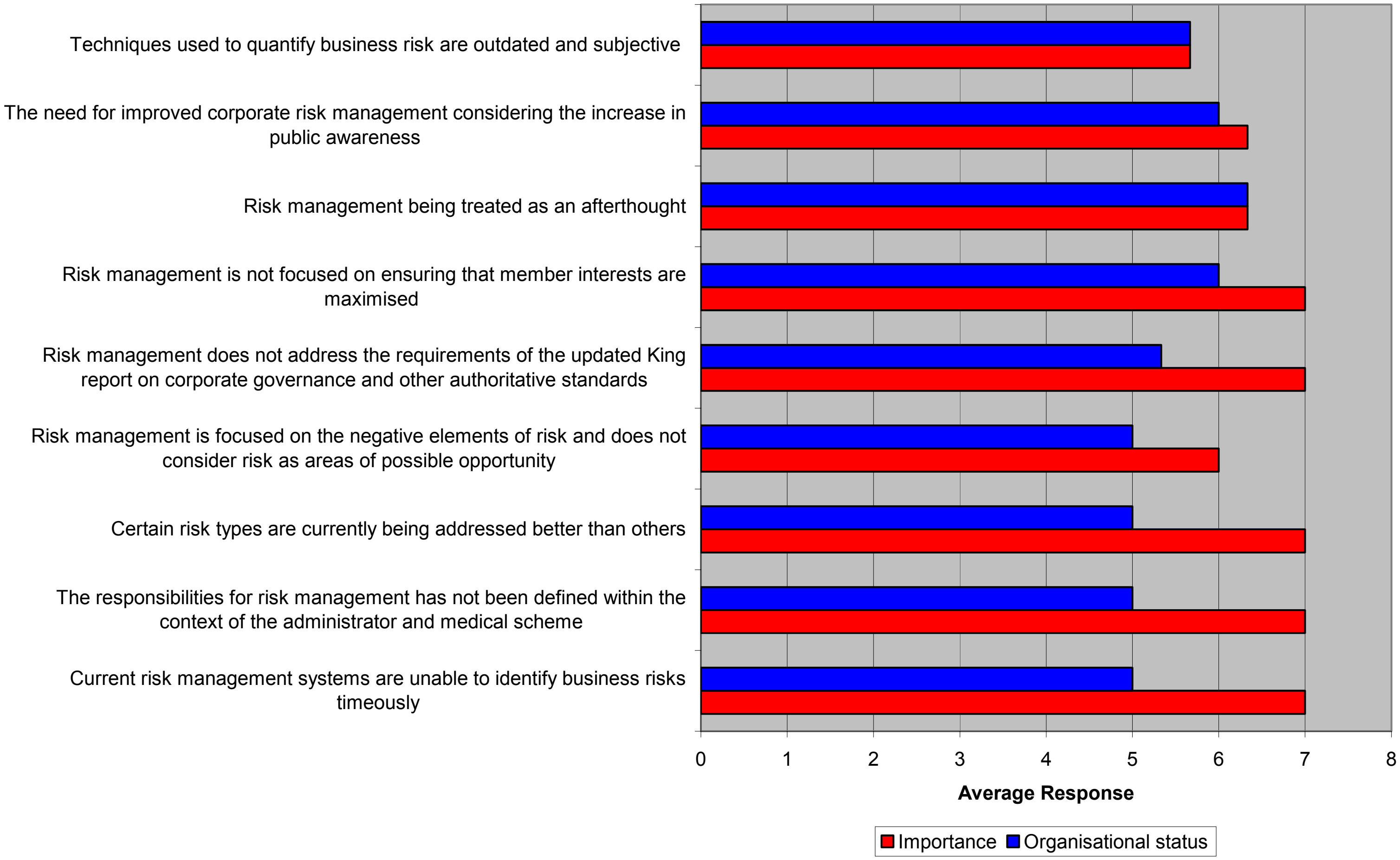


Figure 4.2: Empirical study results: concerns regarding corporate risk management

Which of the following factors regarding corporate risk management within the duties of the administrator are cause for concern and how well are they being addressed?



Results from the empirical study indicate that respondents felt they were utilising a defined process somewhere between the risk management and corporate risk management stages. The following capabilities and benefits were evident (extracted from table 4.1 above):

Capabilities:

- Uniform risk management process
- Roles and responsibilities defined
- Risk management policy followed by all
- Risk measurement
- Consistent risk reporting
- Risk management tolerances initiated

Benefits:

- Risk anticipated better than competitors
- Linkage between risk management and line operations management
- Improved capital and resource allocation
- Risk transparency with stakeholders

Based on the empirical study responses, the most noteworthy issues raised include:

- The revision of past corporate governance standards has increased the importance of corporate risk management.
- Respondents believed that, at the time, they were utilising a defined process somewhere between the risk management and corporate risk management stages detailed in table 4.1.
- The implementation of an effective corporate risk management programme could ensure that strategic objectives are fully assessed before being executed and that only those risks aligned with the organisation’s risk profile were capitalised upon.

- In relation to existing risk management initiatives, respondents believed that certain risks were being better managed than others. In addition, they felt that suitable information systems were not in place to address risks in a timely fashion.
- A need for a defined corporate risk management philosophy within administration organisations was evident.

4.8 Summary

From its insurance origins, risk management has developed into a fully fledged management function and is progressing into business areas that were originally considered unrelated.

The revised corporate governance standards in South Africa make a differentiation between the field of risk management and other traditional assurance services such as internal audit for the first time. This delineation assigns a number of risk management responsibilities to existing key role players within the organisation. In addition to this, a number of new roles are recommended by the revised corporate governance standards.

This chapter focused on detailing the evolution of risk management from an extremely financially focused science to an anticipatory and proactive approach that supports a business model of creating value. The most distinct reasons why past risk management techniques were considered unsuitable was that risks were often assessed in isolation and that past risk management methodologies only focused on the hazardous or downside elements of risk.

The chapter concludes with the following plausible definition for corporate risk management: *Corporate risk management is the structured process of identification, assessment and the continuous management of the combined risks aimed at ensuring stakeholder expectations are achieved.*

The results of the empirical study indicate that members of the medical scheme environment utilise a defined risk management process somewhere between the risk management and corporate risk management stages. The need for a defined corporate risk management philosophy was also noted.

4.9 Conclusion

The evolution of risk management towards corporate risk management recognises that risks are interrelated and that significant benefits may be achieved from evaluating and monitoring on a company-wide basis.

Healthcare administration organisations are on a development continuum with respect to managing risks and creating increased stakeholder value. How far an organisation progresses on this continuum and the rate of such change will be dependant on its past experiences, structural set-up as well as its desire to be world class. For continued success, it is vital that administrators perceive this continuum as a journey and not an event.

The following chapter will introduce the South African private healthcare environment and provide some insight on how these operations function abroad.