

Taking ERM to the next stage

A focus on risk-reward trade-offs

It is time to retool and refocus Enterprise Risk Management (ERM) towards risk-reward optimization. For many health care providers, initial ERM efforts concentrated on identifying and assessing downside operational and business risks. However, ERM's true value-added benefits are realized when risk information is integrated with business decisions to enable management to protect and enhance organizational value in the face of risks and uncertainties. For leading organizations this is the next phase of ERM development.

US healthcare providers operate in a complex and challenging environment in which the type, scope and frequency of business risks are increasing significantly. As healthcare demands increase many hospitals are facing extraordinary cash and capital demands due to margin contraction; lowered investment portfolio performance; and volatile reimbursement and payment models. At the same time they are often caught in a local "arms-race" to provide improved services, the newest technologies and upgraded facilities in order to attract physician groups, nurses and patients and thus maintain or increase market share. Some non-profit providers are also trying to manage regulatory and public scrutiny in maintaining the "right" balance of for-profit and non-profit activities to support their organization's goals. With increasing and competing demands on organizational resources, healthcare senior management must make operational and strategic decisions that effectively and explicitly consider the impact of uncertainties and risks on key organizational and strategic objectives such as cash flow, ROI or margins.

Case study: Risk-based decision making

A mid-size non-profit healthcare provider was considering launching a new bariatric services line. Critical inputs to the decision-making process were a high-level risk assessment of the offering, market and financial analyses, and scenario-based market penetration projections. Based on a traditional market analysis, management presented revenue projections to the Board and these projections then became the expected performance measures for the new service line.

However, the risk assessment element of the materials provided to management identified the following risks:

- Competitors in nearby cities already offered the service
- Difficulty in recruiting doctors
- Timely reconfiguration of facilities and equipment
- Experienced nursing shortage

This high-level risk assessment was not integrated with the financial or market analysis to enable a “risk-adjusted” decision. Put simply, the management team did not determine, beyond a “gut” feel based on combined experience, expected revenue performance of the new service should the potential risks actually occur. Further, there was no methodology applied to understanding the root cause of the risks or how the organization could mitigate the risk.

Based on this lack of integration of risk and return, the organization undertook a more in-depth analysis of the risks to determine the key drivers and the potential impact on the new service line. The analysis revealed that it would take longer than originally envisioned to recruit the necessary doctors and that the key to recruiting doctors was the high caliber and retention of nurses. As a result, the organization redirected resources to a focused nurse recruitment and retention program and also revised the first year revenue projections for the new service.

While management were confident that they always took into account risks when assessing a new investment or capital project, the original risk assessment provided to them was at best “fuzzy” in terms of illuminating how the investment would perform in a real business environment. Based on further analysis of the risk the organization was able to provide realistic revenue estimates to the Board and were also better able to define the necessary resources and actions required to obtain the projected revenue (reward) for the risk of applying capital to this new service.

The dynamic and uncertain business environment has led many large for profit and non-profit US healthcare providers to explore and adopt elements of Enterprise Risk Management (ERM). Over the past five years many organizations turned to ERM to meet Board requests for a deeper understanding of strategic and operational risks. The importance of ERM has recently been accentuated by Standard & Poor's announcement to include ERM ratings in the credit ratings assessments. Against a backdrop of decreasing capital availability, this move puts added pressure on providers to have robust risk management structures.

However, despite some initial early gains, it is arguable that most providers are in the early stages of ERM application and have yet to unlock the full benefits of the concept.

In practice ERM is often limited to qualitative risk assessments of entity-wide risks. Organizations appear to plateau on an annual loop of qualitative risk identification and assessment and the development of loosely defined risk response plans. In many instances the resulting "heat map"-based risk assessments are not aligned to strategic and operational business decisions, such as the decision to develop a new service line (i.e. neuroscience) or undertake a for-profit joint venture with a physician group, but are instead presented in a stand-alone "check-the-box" fashion to senior executives and the Audit Committee.

Where ERM is implemented in this way, it is difficult for senior management and the Board to clearly understand how identified risks will specifically and measurably impact the organization and key elements of performance such as cash flow or patient satisfaction. The information resulting from the ERM process does not provide the necessary information to help the organization make structured and consistent capital and resource allocation decisions that optimize the risk-reward trade-off.

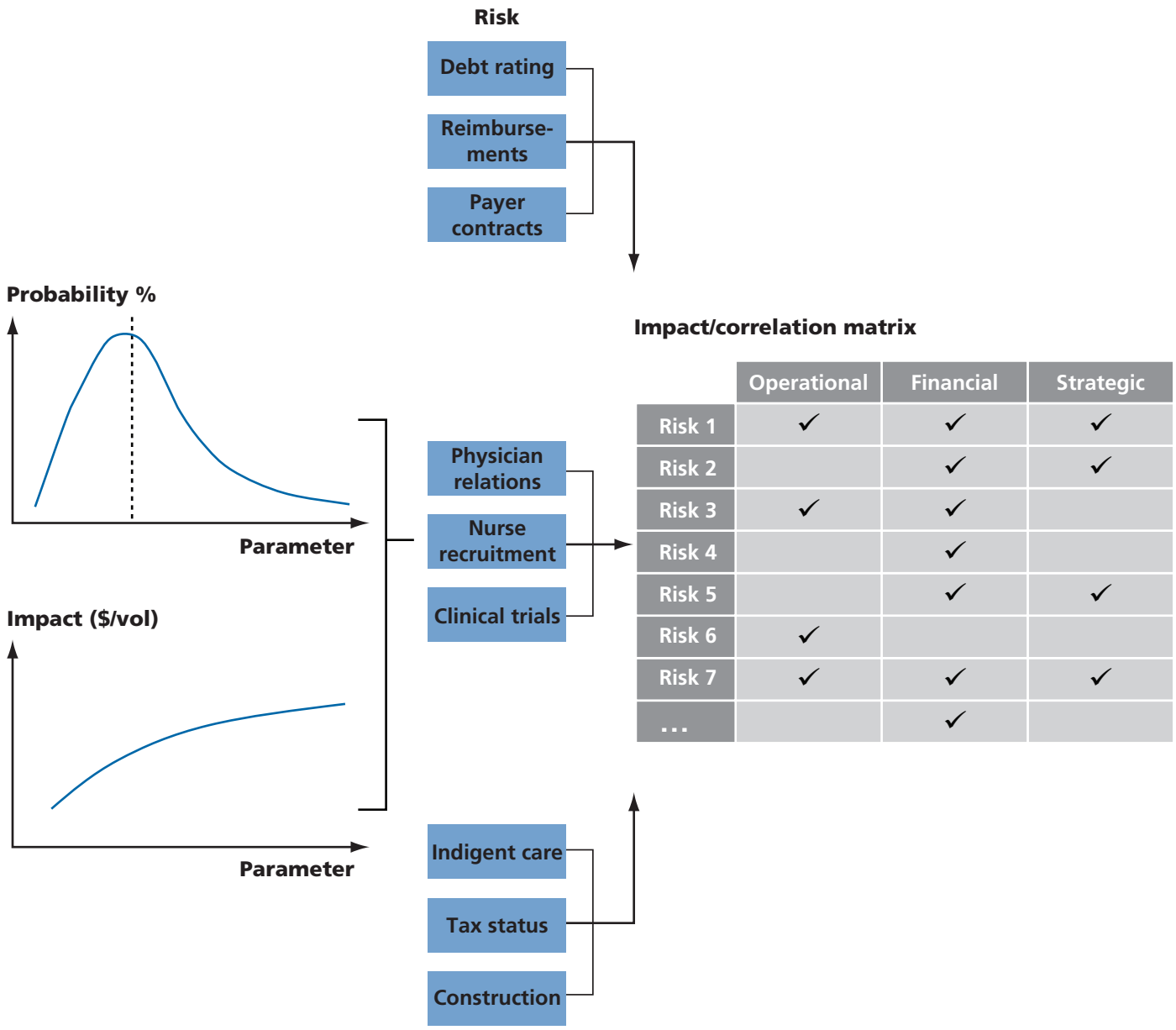
Re-focusing ERM – Getting started

To take ERM to the next level, healthcare providers must:

- Start thinking of ERM as an approach to maximize organizational performance and optimize value within the context of their mission and organizational goals rather than just as a process for risk mitigation
- Build a solid ERM framework that includes appropriate infrastructure, process and governance components as a consistent foundation from which to integrate risk information into key business decision making capabilities
- Develop risk assessments and risk insights that are integrated into the decision-making processes of the organization including resource and capital allocation.

One of the largest challenges in generating applicable risk insights is developing consistent quantitative risk measures and metrics for operational and strategic risks that can then be used to help the organization understand potential risk impact in terms of revenue, cash flow or other such common measures. In many instances there is little empirical or historical data relating to the risk (its impact or likelihood) to support a simulation model of the risk impact. However, leading organizations across many industry sectors have developed risk quantification methodologies that build on widely used ERM baseline capabilities such as management self-assessment techniques, expert opinion or proxy industry data. Fundamental to the risk quantification and simulation process is obtaining and interpreting relevant data from the organization in a practical and understandable manner.

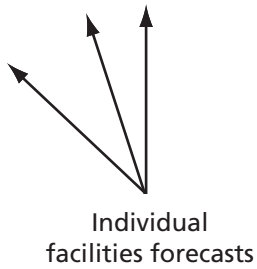
Figure 1: Illustrative risk assessment simulation model outputs



Risk drivers are specified in terms of probability and impact using historical data and/or external or management judgment as inputs

Some risks are specific to individual facilities while others have a broader impact (e.g. rising energy costs)

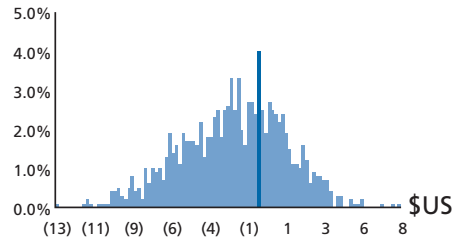
Consolidated network forecast



The risk model takes "base" profit and loss forecasts as the basis for risk quantification analysis

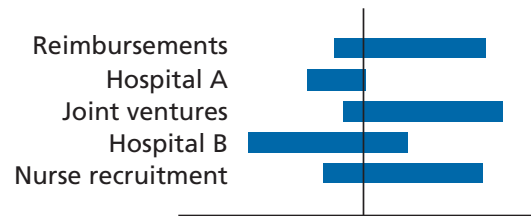
Distribution of earnings

BU & Group EBIT @ risk output

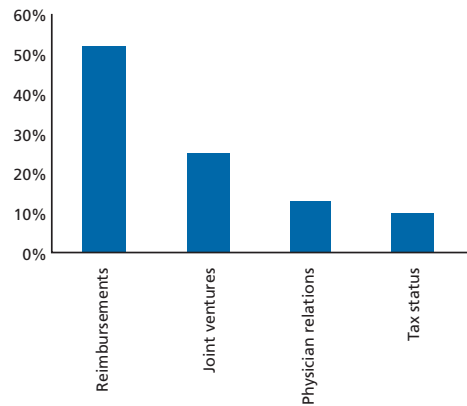


Impact of different risks on EBIT

Forecasted Range of Risk Impacts upon Projected 2008 EBIT



Impact of different drivers on Facility business risk



The impact can be measured against forecasted EBIT, cashflow, etc

Organizations will typically first develop and pilot test this risk analysis methodology on a key project, such as the construction of a new hospital facility, a merger or acquisition of a hospital, or other significant business or strategic activities.

- The process begins with an identification of the key risks, often based on a individual or focus-group self-assessment by management.
- Next, a risk root cause analysis is undertaken in order to identify critical risk drivers and their impact and likelihood parameters, which can then fuel a risk simulation model. Often these inputs are most effectively developed using insights from internal expert sources and existing organizational data, using quantifiable factors for which historical data does exist. For example, to develop the monetary impact parameters of a decline in patient admissions the methodology would use existing financial and reimbursement data.
- In the final step of the analysis, monetized risk impacts are aggregated to simulate risk impacts on cash flow, return on investments or other organizational performance measures. This affords insights into possible deviations from business plan expectations and the contribution of the risks to the entity's overall risk profile.

Too often, critical capital allocation and key strategic decisions are based on limited market or financial analysis supported by managements' "gut" feel drawing on experience. Further, silo-ed risk assessments do not provide applicable information that provides insights into how the identified risks will affect strategic and operational decisions. As a result, senior management and the Board are often "surprised" by unexpected underperformance.

Benefits of improved risk assessment and measurement processes

Strengthening the organization's capabilities to understand how internal and external risks will affect the achievement of their organization's objectives will provide many benefits to management and the Board including the ability to:

- Clearly map and understand the potential impacts of identified risks on key strategic or operational objectives measured in terms relevant to that objective (e.g. return on investment, cash flow or patient satisfaction)
- Improve dialogue between management and Board and with external stakeholders based on processes to better predict and monitor organizational performance
- Consider trade-offs between investment decisions based on objective, comparable and "risk adjusted" data
- Put a structure and objectives around investment and capital allocation processes that are too often informal, inconsistent and highly personalized
- Identify and determine the most effective and capially efficient risk management response to ensure the organization meets the desired performance/return expectations
- Identify risk correlations and how the risks may aggregate to affect organizational performance

Senior executives in the healthcare sector may be sceptical of ERM and perceive it as an unnecessary bureaucratic process that provides little output relevant for business decisions. Given the pressures facing the provider sector, it is time for executives to re-examine initial ERM efforts to consider how they can significantly strengthen their processes to provide useable risk analytics and data that can be integrated into operational and strategic decision making. A bullet list of potential risks with no correlation to market and financial data is a limited basis on which to allocate millions of dollars of scare capital. A robust and consistent methodology will improve decision making and provide assurance to senior management, the Board and outside stakeholders as to the organization's capacity to successfully manage itself in a challenging environment.

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