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**SUMMARY**

**RISK AND THE SOUTH AFRICAN PRIVATE HEALTHCARE –  
AN INTERNAL AUDIT PERSPECTIVE**

by

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The ability to learn from catastrophe and the science of managing such events has plagued man for centuries. From its insurance origins, corporate risk management has developed into a fully fledged management function and is progressing into business areas that were originally considered unrelated. The evolution of risk management towards such a corporate approach recognises that risks are interrelated and that significant benefits may be achieved from evaluating and monitoring them on a company-wide basis.

This study aims at providing the reader with information on the major risks facing the private healthcare administration organisation in South Africa as well as the suitable corporate risk management methodology that may be applied in effectively managing these threats and opportunities from an internal audit perspective.

Pressing issues facing the private healthcare environment today include:

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- Dramatic increase in regulatory oversight within the private healthcare industry;
- the need for more innovative actuarial and financial models to address countrywide epidemics such as HIV and AIDS;
- increased prevalence of capitation contracts to ensure the financial stability of healthcare service providers;
- increases in expected fraudulent activity;
- increasing the scope of private healthcare to incorporate a larger share of the South African population; and
- providing effective healthcare cover to members whilst facing significant medical inflation increases.

The development and implementation of a consistent risk management methodology provides stakeholders with greater confidence that pressing issues, such as those listed above, are being optimally managed. This type of improved risk management consists of distinct phases. Key phases of the suggested methodology presented in this work are supported by results from an empirical study representing 27% of the registered medical schemes in South Africa.

Based upon assessments of literature, current definitions for risk and corporate risk management are also presented. Also, the study will be approached from the perspective of the internal auditor, with suitable insights and suggestions made from this standpoint.

The study concludes with the author's evaluation of the current state of risk management for private healthcare administration organisations in South Africa and future predictions regarding this management field.

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# Chapter 1

## Introduction

If we want things to stay as they are,  
things will have to change

Giuseppe di Lampedusa 1896-1957

Change is no longer linear, but exponential

De Loach, 2000:8

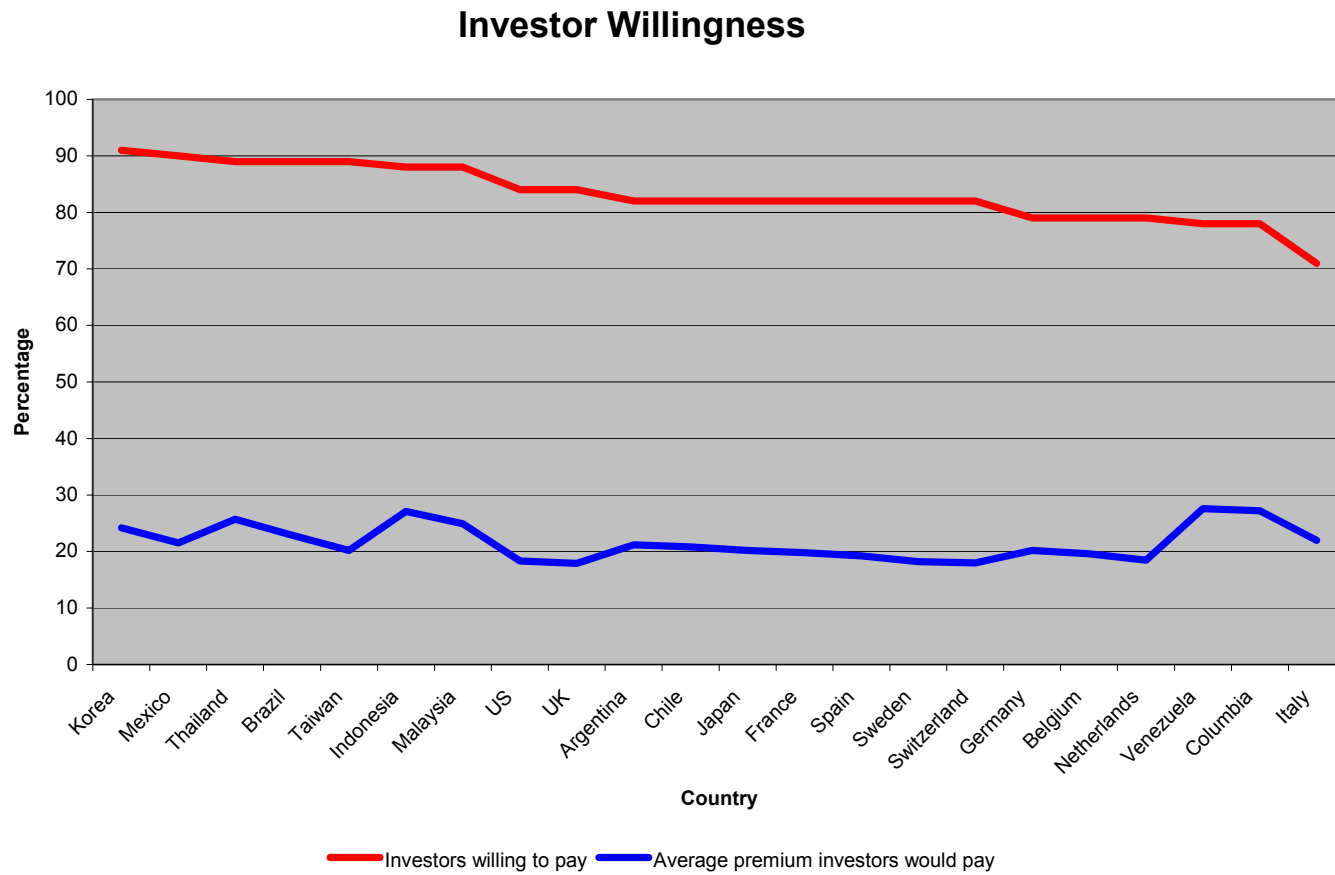
## **1.1 Background**

Constant change in the business environment exposes corporations to new risks that require unique solutions. The types of new risks faced by businesses are considered endless and necessitate the effective coordination of limited resources (Makhari, 2001). New risk types include reputation, e-commerce and earning volatility (De Loach, 2000: 25-28). It is perceived that the only way in which such future challenges can be faced, is to give urgent attention to improving corporate governance standards, standardising risk management techniques and furthering best practice (Makhari, 2001).

Mervyn King commented that international investors are willing to pay a premium for companies with good corporate governance (Chalmers, 2001). King's statement is confirmed by an international study conducted by McKinsey & Company in figure 1.1 below. The study indicates that over 80% of surveyed investors are willing to pay a premium of between 18 to 27% for organisations that administer an effective corporate governance programme. Corporate risk management forms an integral part of such a programme. (Pickford, 2001: 293).

Table 1.1 provides a summary of results from a KPMG corporate governance survey conducted in 2001. In the survey, the importance of risk management amongst other various elements of corporate governance criteria is emphasised. Respondents include approximately 30% of companies listed on the South African JSE Securities Exchange.

Figure 1.1: Investor willingness (McKinsey & Company, 2000)



Since today's fast paced business environment bombards organisations with a diverse array of risk events, organisations are developing a variety of risk management strategies. In this environment, internal auditors have an opportunity to contribute to, or even drive, their client's corporate risk management activities (Roth *et al.*, 2002: 57).

The R30 billion a year private healthcare administration industry in South Africa is undergoing rapid change and faces significant instability (Shevel, 2001). Not only is the environment becoming increasingly complicated, there is also an attendant increase in regulatory oversight (Huntington, 2001). Furthermore, recent newspaper articles relay concerns that private healthcare funders will reserve the right to send their members to public institutions due to the rising costs associated with service provision (Moya, 2003a: 1).

The remaining portion of this chapter will highlight some of the most noteworthy challenges facing the private healthcare industry.

**Table 1.1: Corporate governance priorities (KPMG, 2001)**

<b>Corporate Governance Factor</b>	<b>Increase emphasis (%)</b>
1. Employment equity/transformation	56
2. Succession management	56
3. Management performance and effectiveness	50
4. Organisational performance measures	48
5. Vision and Strategy	47

Continued...

<b>Corporate Governance Factor</b>	<b>Increase emphasis (%)</b>
6. Board composition and leadership	44
<b>7. Risk Management</b>	<b>42</b>
8. Board accountability, remuneration and performance	41
9. Internal control	34
10. Values and ethics	33
11. Internal and external reporting	32
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## **1.2 Challenges facing South African private healthcare**

At present, 16% of South Africa's population is supported by private healthcare (Bisseker, 2001: 34). The following significant challenges are facing the private healthcare environment:

1.2.1 Effectively manoeuvring an environment facing continuous volatility in terms of legislative requirements:

- Possible implementation of risk equalisation which would compel medical schemes to compete on the basis of their ability to contain



costs through their benefit structure and by encouraging members to make effective use of healthcare services (Editorial 2001a: Sector braces for social health move).

- Inability to deny health cover to high-risk individuals thereby limiting the medical schemes ability to protect the funds of healthier members (Jackson, 2001). The Medical Schemes Act was revised in 1998 to broaden access to those traditionally denied cover. The immediate impact was a dramatic increase in existing member contributions. Hardest hit were the young and wealthy whose contributions had to be increased by as much as 200% in 2000 to cross-subsidise the sick and old (Financial Mail, 2000: 365). Overall, private healthcare membership has stagnated to approximately 7 million with an overall increase in older members (Bisseker, 2001: 34). In 2003, medical scheme membership is still pegged at 7 million (Kahn, 2003: 1)

It is estimated that 85% of employers who partially contributed towards employee's medical aid contributions noted a rise in such costs following the reform of the Medical Schemes Act. In addition to raising contributions to combat the initial negative impact of the reform, employers were tending to reduce benefits to members (Heard, 2001).

- Raise and manage capital so that the administrator of the medical scheme maintains prescribed solvency ratios. The Regulations to the Medical Schemes Act of 1998 provide that the scheme should maintain accumulated funds, expressed as a percentage of gross annual contributions. Medical aid schemes are required to attain a solvency level of 13.5% of contributions by the end of 2001. By the end of 2002, schemes have to reach a solvency level of 17.5% (Du Preez, 2001).
- The introduction of amnesty periods during which late joiner penalties would not be applied to people who joined schemes for the first time in their lives. The industry estimated that 150 000

families qualified for such amnesty in 2000. The inability of medical schemes to charge penalties for late joining has a dramatic effect on the medical contributions charged to existing contributors of the scheme (Financial Mail, 2000: 366).

Duff & Phelps Credit Rating Co. had the following to say regarding the increased legislative requirements (Financial Mail, 2000: 374):

*“The new act is expected to induce an increase in merger activity as those schemes that are less capable of absorbing these new pressures enter into strategic partnerships and amalgamations... inevitably some schemes will also fall by the wayside.”*

In a research report conducted by the Council of Medical Schemes, the following were identified as additional areas where increased regulatory oversight could be expected (Markdata, 2001: 20):

- Ensure quality services;
- regulate and lower cost of membership;
- act against corruption;
- ensure satisfaction of beneficiaries;
- provide information to beneficiaries;
- ensure rapid claim processing;
- ensure full coverage of costs;
- ensure non-discrimination;
- ensure financial stability of medical schemes;
- act on complaints;
- provide training to beneficiaries;
- regulate governance of medical schemes;
- ensure competence of medical scheme staff;
- ensure full family coverage;
- allow flexibility of payment;
- effective management of chronic illness benefits;
- standardise fees; and

- ensure minimum benefits.

Stakeholders represented in the survey included 16 various industries, e.g. council members, healthcare providers, healthcare administrators and managed care organisations.

1.2.2 In February 2001 a more rigorous auditing and accounting guideline on medical schemes was issued by the South African Institute of Chartered Accountants. The Institute convened a project group representing the broad spectrum of the medical schemes industry to align existing financial reporting by medical schemes with international standards. (Hymans, 2001). The updated guideline addresses issues such as legislation, corporate governance, auditing and uniformity of financial reporting.

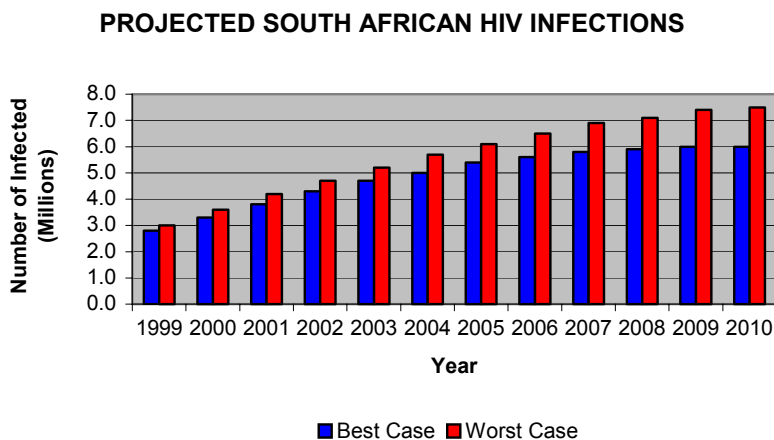
1.2.3 To provide cost effective cover to members suffering with terminal diseases such as HIV and AIDS without increasing membership costs of other healthier members (Editorial 2001b: United effort can contain AIDS). Certain nationally accepted projections on South Africa's population for 2020 were initially set at 80 million. These have, however, been revised to roughly 50 million due to the effect of HIV and AIDS (Thomas *et al.*, 2001).

Table 1.2 below provides a comparison between the private and public healthcare sector costs for treating an HIV patient. Figure 1.2 provides projections on the expected increase in HIV infections over the next 10 years.

**Table 1.2: Average cost per patient comparison (SAHR Report, 2000a)**

<i>HIV Development Stages</i>	<i>Average Cost Per Patient (Rands/Yearly)</i>	
	<i>Private Medical Schemes</i>	<i>Public Healthcare</i>
Stage 1 and 2 (Initial)	3 000	1 300
Stage 3 (Advanced)	14 200	6 200
Stage 4 (AIDS)	38 300	17 000

**Figure 1.2: Projected South African HIV infections (SAHR Report, 2000b)**



1.2.4 Increasing prevalence and complexity of service capitation contracts entered into between medical schemes and service providers. (Finger, 1998). Such contracts provide for a per diem rate (i.e. a fixed daily rate as opposed to a charge per item) for procedures that contribute towards the improved management of provider costs. The per diem rates, which were negotiated in 2000, awarded hospital groups an effective 7% increase compared to hospitals demands of 9% (ibid.).

These capitation contracts often form part of a movement in private healthcare referred to as managed care organisations (Academy for Health Care Management, 1999: 2-5).

1.2.5 Dramatic increase in the extent of fraudulent activity by service providers and members within the private healthcare environment (Huntington, 2001). The 1999 KPMG South African Fraud Survey indicated that 86% of respondents from various industries believed that the future extent of fraud would increase (KPMG, 1999: 2). In a similar survey conducted in 2002, 75% respondents believed that fraud would increase (KPMG, 2002: 6). In both surveys, it was indicated that the most appropriate way in which this increase could be curbed was by way of improved internal control.

1.2.6 Maximising operational performance in terms of (Academy of Healthcare Management, 1999):

- Paying service providers accurately and timeously;
- bearing or sharing the risk of not having sufficient funds to support its ongoing operations;
- determining the rates to be charged for its products without violating existing legislative standards;
- planning strategically for growth and expansion of products by continuously scanning the medical needs and requirements of current and prospective members;
- analysing financial markets and information; and
- managing the flow of funds into and out of medical schemes.

1.2.7 Industry is searching for a cost-effective mechanism to provide benefits to an additional 7 million South African blue-collar workers who have jobs but are uninsured.

Many medical schemes have attempted to enter into this low-income market through the use of service capitation contracts but have found it difficult since it involves a switch to a new business paradigm (Financial Mail, 2000: 368). The poor level of service provided by the current public healthcare industry in relation to its private counterpart is increasing pressure on the private industry to identify new ways in entering this volatile market. Tables 1.3 and 1.4 below provide details on the response between current public and private healthcare while Figure 1.3 indicates how the need for the broadening of access to groups previously excluded, is on the increase.

**Table 1.3: Reactions to public healthcare** (Markdata, 2001: 27)

<i>Criteria</i>	<i>%</i>
Public healthcare adequate	9
Public care needs improvement	35
Use of private facilities essential	56

**Table 1.4: Preferred modes of service delivery** (Markdata, 2001: 27)

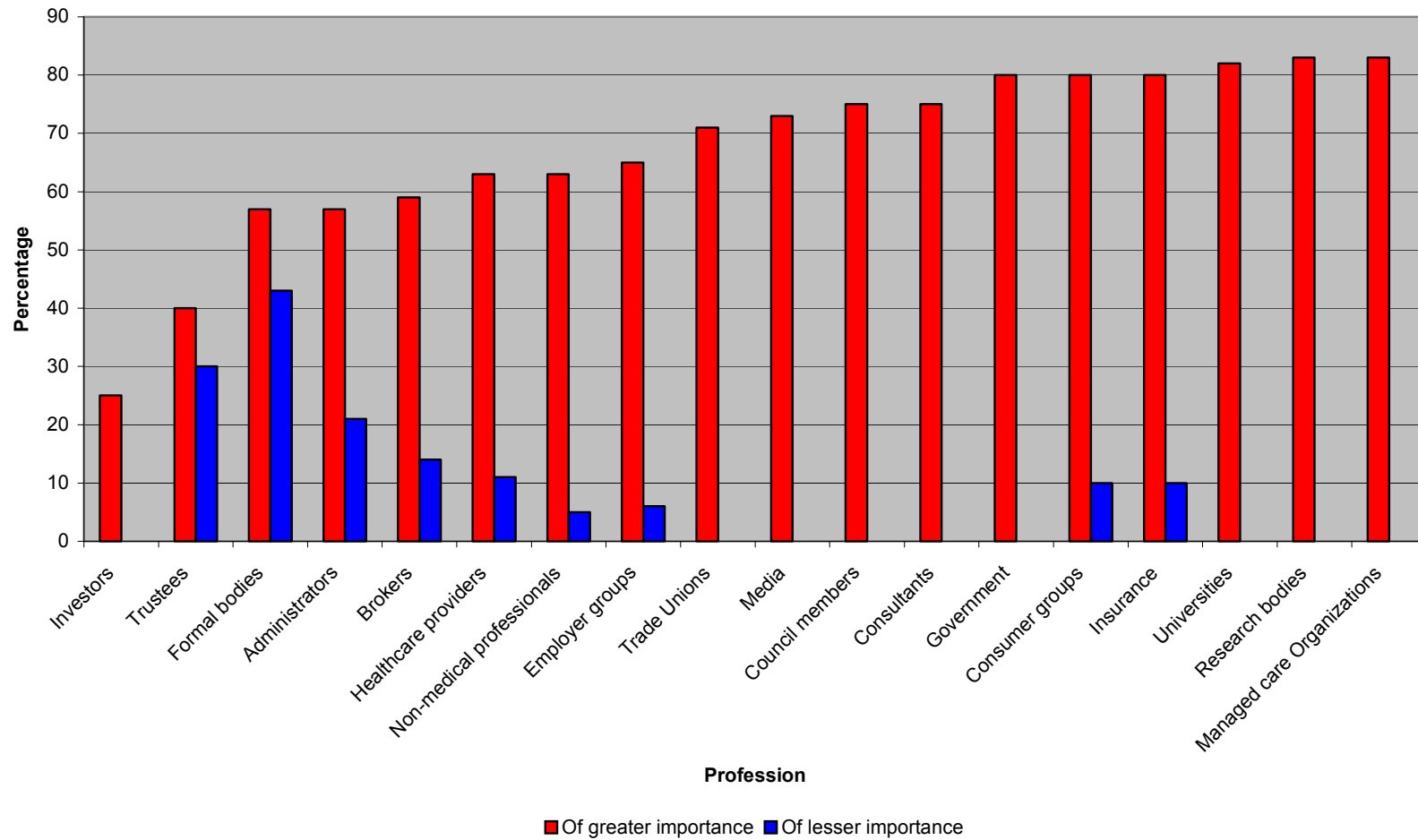
<b>Criteria</b>	<b>%</b>
Private medical schemes	49
Free or low cost public healthcare	19
Health insurance for high costs	18
State subscription based medical scheme	13
Other responses (various)	1

1.2.8 For most of the nineties, medical inflation exceeded general inflation causing health care benefits to consume almost 10% of the average employer's payroll costs. For the 2001 year, most schemes increased their contribution rates by 17% on average. Since employers can no longer afford such substantial increases, many will seek ways of reducing medical benefits to contain costs. It is expected that, should such trends continue, a member may be spending almost 30% of his or her salary on medical aid by 2009 (Bisseker, 2001: 34). Over the past decade premium increases have generally exceeded the Consumer Price Index (CPI) by 5%. For 2003, medical premiums are set to rise between 12% to 18%, whereas CPI is expected to be between 7% to 7.5% (Kahn, 2003: 1).

In a bid to ease the rampant increase in medical premiums, new regulations will take affect under the Medical Schemes Act at the start of 2004. These new regulations will give private healthcare funders the right to force members to use public hospitals for certain conditions, including some conditions which are expensive to treat (Moya *et al.*, 2003b: 3). Illnesses for public care include (ibid.):

- Asthma;

**Figure 1.3: Broadening access to groups previously excluded (Markdata, 2001: 49)**





- glaucoma;
- epilepsy;
- drug addiction;
- Parkinson's disease;
- HIV testing, antiretroviral prophylaxis after rape or exposure to HIV; and the prevention of maternal transmission of HIV.

1.2.9 To meet the challenges of containing medical inflation and extending medical cover to lower income groups, scheme administrators require up to date data on claiming patterns, trends, pricing movements, utilisation variations and cash flow. (Editorial 2001c: The age of cost busters). This will drive many healthcare administrators to employ complex and risky mathematical models and information systems to ensure survival and benefit optimisation for members.

From the above challenges it is seen that the private healthcare administration organisation faces some significant risks now and into the future. Healthcare financiers will need to develop more innovative methods and risk management processes to ensure that members are provided with the most comprehensive benefits at the lowest cost possible (Huntington, 2001).

### **1.3 Purpose and reason for study**

#### *1.3.1 Purpose of study*

The purpose of this study will be to:

- identify risks facing the South African private healthcare administrator, and
- develop a suitable corporate risk management programme for the industry.

The study will be approached from the perspective of the internal auditor, with suitable insights and suggestions made from this standpoint.

### 1.3.2 Reason for undertaking study

Based on an evaluation of South African healthcare administration literature relating to corporate risk management, it would seem that little attention has been given to this field of study. The following specific areas of weakness have been identified<sup>1</sup>:

- Slowness of South African healthcare private administrators in adopting corporate risk management;
- increased regulatory risks that could be effectively addressed by a corporate risk management programme;
- slowness of professional bodies in promoting corporate risk management as one of the key processes within business management; and
- lack of industry awareness regarding developments in the field of corporate risk management based on international best practice.

### 1.4 Research methodology

The research methodology applied in this study consists mainly of an evaluation of literature in the fields of business management, internal auditing and risk management.

To identify the most pressing issues relating to corporate risk management and private healthcare administration, the results of an empirical study are presented in appropriate chapters.

### 1.5 Summary and conclusion

In this chapter, the author identifies the purpose of the study as being:

- The identification of risks facing the South African private healthcare administrator, and

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<sup>1</sup> Assumption based on author's personal evaluation of risk management literature:

- Valsamkis, 2000
- Vivian, 1996, 1985
- De Villiers, 1991
- Morkel, 1988

- developing a suitable corporate risk management programme for the industry.

The chapter provides detail on what has heightened the need for a more up to date risk management process within the healthcare administration environment. The most noteworthy of these being:

- Dramatic increase in regulatory oversight within the private healthcare industry;
- more exacting accounting and auditing standards;
- the need for more innovative actuarial and financial models to address countrywide epidemics such as HIV and AIDS;
- increased prevalence of capitation contracts to ensure the financial stability of healthcare service providers;
- increases in expected fraudulent activity;
- Increasing the scope of private healthcare to incorporate a larger share of the South African population; and
- providing effective healthcare cover to members whilst facing significant medical inflation increases.

The field of risk management is an exciting and dynamic process that may add untold value to the healthcare financier. This is necessary in an industry where expertise is thinly spread and operational risk and the prevalence of regulatory oversight are on the increase.

The following chapter will formally introduce the concept of risk, its origins and associated philosophy.

# Chapter 2

## Risk

Risk in our world is nothing more than uncertainty about the decisions that other human beings are going to make and how we can best respond to those decisions

Pickford, 2000: 9

The goal of wresting society from the mercy of the laws of chance continues to elude us. Why?

Bernstein, 1998: 330

## 2.1 Introduction

In the most general sense, any activity undertaken by a business entails some form of risk and ultimately every risk has the potential to impact the business (Academy for Healthcare Management, 1999: 2-5). Risk is a concept that is used to express concerns regarding the probable effects of an uncertain environment.

Since the future cannot be predicted with certainty, business has to consider a range of possible events that may take place. Each of these events could have a material effect on the private healthcare administrator's business objectives. The negative possibilities are called risks and the positive possibilities, opportunities (McNamee, 1996: 3-4).

To achieve these objectives, business management will lay assets at risk. The assets at risk include financial, physical, human and intangible assets (ibid.). It will be seen later in the chapter that uncertainty and randomness exist within the risk concept.

Managing risk is a key business function and a vital part of the private healthcare administrator's activities. It aims at ensuring that members' interests are protected and that suitable benefits are provided at reasonable cost (Academy for Healthcare Management, 1999).

Before embarking on defining a suitable risk management methodology for South African private healthcare it is necessary that the author define what risk is, how it has developed and the various natures it may portray within the business context.

On a final note the author will introduce the concept of internal auditing and the background regarding its professional governing body, viz. The Institute of Internal Auditors.

## 2.2 Aim

Issues to be addressed in this chapter include the origin of risk, mankind's perception of the risk concept, risk's philosophical components and the establishment of a plausible definition for risk. The concept of internal auditing is also discussed.

## 2.3 Origin of risk

The beginnings of risk have been traced as far back as 3500BC where the first game of chance was played (Bernstein, 1998: 13). Subsequent developments, which include the introduction of the numbering system and the development of the probability theory in 1654 were, however, the first milestones set in progressing the field of risk management. These subsequent developments were encouraged during the Renaissance and the Reformation, which brought about a change in the manner in which people perceived the future (Pickford, 2001: 6).

Fifty years after the development of the probability theory, the building blocks of statistical sampling, statistical significance and the application of probability theory to practical problems was noted (ibid.). Table 2.1 provides a chronological summary of the development of risk up until the 1970's. The following sources were referred to in preparing the summary:

- Bernstein, 1998: 13-56
- Pickford, 2001: 7

Table 2.1 - Chronological development of risk

<p><b>3500 BC</b> First form of gambling being a type of dice game using astragalus (i.e. animal knuckle bones).</p>	<p><b>1696</b> English mathematician and astronomer, Edmund Halley, shows how life tables may be used to price life insurance at different stages.</p>
<p><b>450 BC</b> Greeks devise an alphabetic numbering system using 24 letters of the Greek alphabet and three letters that subsequently became obsolete.</p>	<p><b>1713</b> Swiss mathematician, Jacob Bernoulli's, "Law of Large Numbers" is published, showing how probabilities and statistical significance may be identified from limited information.</p>
<p><b>1000-1200 AD</b> The Hindu-Arabic numbering system is devised with the invention of the abacus.</p>	<p><b>1733</b> French mathematician, Abraham de Moivre, proposes the normal distribution, the patterns in which a series of variables distribute themselves around an average, from which he also derives the concept of standard deviation.</p>
<p><b>1202</b> Leonardo Pisano suggests the replacement of letter usage in counting and calculations with a numeric system based on the Hindu-Arabic numbering system. The double entry bookkeeping system is also introduced.</p>	<p><b>1738</b> Jacob Bernoulli's nephew, Daniel, introduces the concept of utility: decisions relating to risk involve not only calculations of probability but also the value of the consequence of the risk taker.</p>
<p><b>1494</b> Luca Paccioli introduces the fundamentals of algebra and multiplication tables and extends on the double entry bookkeeping system suggested by Leonardo Pisano.</p>	<p><b>1885</b> English scientist, Francis Galton, discovers regression to the mean, the tendency of extremes to return to normal or average.</p>
<p><b>1525</b> Girolamo Cardano postulates the concept of chance, which would be the basis for future development of probability theory.</p>	<p><b>1944</b> In Theory of Games and Economic behaviour, US academics, John von Neumann and Oskar Morgenstern, apply the theory of games of strategy (in contrast to games of chance) to decision making in business and investing.</p>
<p><b>1654</b> French mathematicians, Blaise Pascal and Pierre de Fermat, analyse games of chance, providing for the first time a formal and mathematical basis for the theory of probability.</p>	<p><b>1952</b> US economist, Harry Markowitz, demonstrates mathematically that risk and expected return are directly related but that investors may reduce the variance on their investments by diversification without loss of expected return.</p>
<p><b>1662</b> English merchant, John Graunt, publishes tables of birth and deaths in London using innovative sampling methods. He estimates the population of London by the technique of statistical inference.</p>	<p><b>1970</b> US academics, Fischer Black and Myron Scholes, publish a mathematical model for calculating the value of an option.</p>
<p><b>1687</b> Edward Lloyd launches Lloyd's List, giving information on aspects of shipping from a network of European correspondents.</p>	

## 2.4 Human perception of the risk concept

Although the concept of risk the author applies in the remainder of this study focuses on the three key elements of uncertainty, future and the effect on organisation's goals, the human's perception of risk is considered to focus on an additional two components. These being the fear factor – the extent to which he dreads the outcome – and the control factor, i.e. the extent to which he is in control of the events (Pickford, 2001: 26-29). How each individual responds to the elements of risk is driven by his perception of loss and gain, cognitive biases and personality (ibid.).

D. Kahneman and A. Tversky in their work titled, *Prospect Theory* (Kahneman *et al.*, 1979: 262-290), showed that when people are in a position of gain, they become increasingly risk averse and unwilling to accept gambles because they wish to hold onto their fortunes. However, when people are in a position of loss and as losses increase, they become more risk keen since they stand to lose little. It is important to note, however, that personal perception of loss and gain is not straightforward and that each person has varying internal reference points that determine whether they will perceive an outcome as a loss or gain. These reference points have been known to shift over time.

Cognitive biases, often termed rules of thumb, enable people to reduce the time they spend processing information and make judgements at high speed rather than deliberate over each of the elements of the decision. However, such cognitive biases may over simplify decisions, which require more in-depth deliberation. Common types of biases include (Pickford, 2001: 27-28):

- *Retrievability*: Basing risk decisions on information that is more easily available or most easily recalled.
- *Confirmation*: Accepting information that confirms established hypothesis and rejecting information that is to the contrary.
- *Illusion of control*: Believing that one has the ability to change risk factors when in fact the most appropriate action would be to either accept or avoid such exposures (Langer, 1975: 311-328).



Personality includes a number of inherent dispositions, feelings, biases and characteristics that tend to be manifested in preferences, sensitivities, habits and reactions. These elements may underlie the way in which each person approaches risk and whether a situation is seen as an opportunity, uncertainty or hazard. One of the most important elements of personality that is linked to risk is sensation seeking. Persons who do not have sensation seeking tendencies and people who by nature experience emotions that are more negative often focus on the potential for loss. They believe that any potential gains are no compensation for the losses that taking a change may entail (Soane *et al.*, 1998: 159-172).

It is the author's opinion that the management of risk within an organisation may be significantly improved when the abovementioned influences are adequately accounted for. A management ethos that acknowledges the individualistic and variable nature of risk perception and ensures the open discussion of such subjective elements will go a long way in increasing the effectiveness of overall decision making within the organisation.

## **2.5 Philosophy of the risk concept**

As seen above, people evaluate risks in incompatible ways and propose conflicting proposals for mitigating or litigating risk issues. The sources of contention are multiple. Sometimes people differ because they have different information; sometimes they differ because they have incompatible interests. The philosophical basis for contention over risk is most evident in the scholarly and scientific literature. As will be seen later, experts who study risk or risk issues are more likely to develop well-defined, internally consistent conceptions of risk than members of the lay public. Should distinct philosophical and linguistic presumptions underlie competing conceptions of risk, it should be possible to formulate the contentiousness over alternatives in terms of a principled philosophical debate with implications for risk analysis, risk evaluation and risk communication.

K. Shrader-Frechette offered a systematic classification for competing conceptions of risk in a 1991 book, which describes two positions in the philosophical debate over risk (Shrader-Frechette, 1991: 56). On one side, positivists believe that risk is a purely scientific concept admitting complete characterization and analysis through data collection and quantitative methods. Opposed are relativists who believe that risk is a purely subjective reaction to phenomena encountered in personal or social experience. Whereas the positivist interprets risk as referring objectively to the circumstances of the physical world, the relativist takes risk to a purely mental construct expressing emotional, moral or political reactions (ibid.).

In 1993, Hornig offered a dichotomous schema that was similar in many ways to Shrader-Frechette's classification process, however, in place of relativism Hornig offered a contextualist view. On this view, the social contexts in which issues or decisions arise determine which dimensions of risk are most important. Hornig does not propose, as one of Shrader-Frechette's relativists may, that lay assessments of risk are just as accurate as expert assessments but she does assert that lay assessments may be more sophisticated than scientific assessments. While expert assessment is quite likely to be more accurate in measuring dimensions of risk deemed important by the scientific community, experts may fail to recognise other dimensions such as voluntariness, which may be more relevant to the points of decision in a given context (Hornig, 1993: 56).

Instead of concluding that neither Shrader-Frechette's or Hornig's approach to risk is in diametrical opposition, the author suggests that these two approaches represent opposite ends of a continuum in which understandings of risk can be plotted between the poles of positivism and contextualism. Few, if any, truly hold the extreme views but several different options can be mapped out in between.

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Strictly speaking, the positivist takes probability to be the only essential characteristic of risk but even those closest to the probabilist pole usually presume that risk is also characterised by some element of negative or unwanted consequence. It is typical to hear positivists refer to risk in ways that permit direct substitution of the word probability without substantial transformation of meaning. The contextualist, on the other hand, claims that no single attribute is a necessary condition for the existence of risk. In this, the contextualist appears committed to the view that certain instances of risk involve no elements of probability or chance. It is, again, important to recall that the pole positions of the positivist and contextualist represent limited cases. The more important implication of the contextualist view is that there will be certain cases in which estimation and clarification of probabilities are largely irrelevant to understanding risk as well as to assessment, acceptability and even mitigation of risk (Thompson *et al.*, [s.a]).

It is quite likely that positivists and contextualists will also have rather divergent perspectives on risk communication (*ibid.*). Positivists are likely to believe that people are generally unaware of probabilities and that they need to know about such concepts to have adequate information regarding risk. Given this starting point, risk communication is largely a process of disseminating information about probability. On the other hand, contextualists are less likely to approach risk communication with any specific assumptions on what people need to know. For the contextualist, risk communication will be construed as bridging the gap between groups who share a particular social context and have evolved patterns for conceptualising and discussing risk within that context. The divergence between the positivist and contextualist approaches to risk communication is an example of a more general pattern in science communication studied by J. Zimon. Zimon describes three models for science communication (Zimon, 1992):

- *Deficiency model*: The deficiency model takes the general problem of science communication to be one of public ignorance, "which must by all means be overcome." (Zimon, 1992: 14). This view arises out of the assumption that the great majority of ordinary people have very little

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understanding of science and is typified by science communication efforts that stress knowledge of facts and theories. Zimon faults the deficiency model for presuming that scientific knowledge tends to be misrepresented and misunderstood outside the boundaries of the scientific community. He states, "Scientists themselves do not have a clear and consistent notion of what 'science' covers and often disagree profoundly on what it is telling us about the world." (Zimon, 1992: 16).

- *Rational choice model*: This focuses on those points where a particular piece of knowledge may be expected to play an important part in people's lives (ibid.). Here, the goal of science communication is to supply the missing piece of knowledge. Zimon notes the close association between the deficiency and the rational choice models but the problem of the rational choice model resides in the way it construes "need to know" situations. Certainly, there are circumstances in which a key piece of information (some facts about probabilities, for instance) are relevant although many problems of everyday life are better characterised as problems of information management. Knowing where to go for information and whom to trust is often more important than knowing key facts. It is this kind of information that comes to the fore in what Zimon calls the context model.
- *Context model*: This model recognises that a person's desire for information is shaped by their circumstances, that the credibility of a source depends heavily on its perceived interest in a particular context and that scientific information will be combined with broader values in forming any individual's personal beliefs (Zimon, 1993: 18-19).

In applying the above models to the role of the positivist, he is likely to perceive risk communication as the dissemination of information about probability and consequence when following Zimon's rational choice model. Facts about probability and consequence will be presumed to be what the ordinary person "needs to know," to make better decisions. Following the deficiency model, the positivist may also perceive risk communication as involving the promotion of a conceptual framework for utilising probability and consequence information in personal choice and public policy. When the two

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are combined, the positivist perceives risk communication as publicising facts about probability and consequence, correcting false perceptions, dissociating accidental dimensions from people's understanding of risk and as encouraging a choice procedure that interprets every choice as involving risk. The probabilist approach to risk communication, in other words, includes a broad philosophic commitment to a particular view of decision making and rational choice.

In applying the above to the position of the contextualist, it is clear that the word "risk" does not mean only one thing. Contextualists presume that people acting from different social or problem solving contexts have distinct notions of risk and demands for both factual knowledge and evaluative judgment on risky situations. Risk communication is, on Zimon's context model, a process of attempting to establish dialog between individuals and groups with very different conceptions of risk. Because of these differences, risk assessment is a process fraught with opportunity for confusion, distrust and even deceit. A successful risk communicator is one who succeeds at negotiating meanings and mediating diverse discourse communities who have some need to interact.

Hornig makes the case for the context model in risk communication by suggesting that scientists have a less sophisticated understanding of risk than the lay public (Hornig, 1993). It is true that positivist's conceptions of risk tend to presume Zimon's deficiency and rational choice models and that these models represent a somewhat unsophisticated understanding of communication. Yet, it is not unclear that scientists, as a group, are committed to the positivist conception of risk, nor is it obvious that positivist conceptions of risk are less sophisticated than the contextualist's perception.

The author can, therefore, conclude that risk positivism and risk contextualism represent the opposite ends of a continuum for conceptualising risk. Scientists and scholars who study risk and risk issues are likely to adopt conceptions of risk that fall somewhere along the axis between extreme positivism and extreme contextualism. Their relative positions will fix many of their methodological assumptions for risk analysis and risk communication

and will probably reflect other philosophic commitments such as their broader view of how science should play a role in public policy or in the personal decision making of ordinary people. Clearly, the continuum between positivism and contextualism does not map every contentious issue in risk studies. Even positivists who share the same general conception of risk may find much to dispute when choosing the particular quantitative representation of that conception and such controversies pale in comparison to those in which large commercial interests are affected by key choices in risk assessment methodology (Thompson *et al.*, [s.a.]).

## **2.6 Definition of risk**

No universal definition of the term risk exists (Skipper, 1998: 6). The word risk derives from the early Italian *risicare*, which means “to dare” (Bernstein, 1998:8). Since the general term, risk, is found within numerous disciplines ranging from insurance to actuarial science, it is understandable that such varying definitions of the term are found. Respective authors have been careful to qualify their interpretations based on the particular orientation of their research (Valsamakis *et al.*, 2000: 33).

The perception of risk is considered to be a complex and subjective process (Pickford, 2001: 25). Key sources identify risk as being inextricably linked to the term uncertainty (Valsamakis *et al.*, 2000: 30 and De Loach, 2000: 49).

Uncertainty is defined as “doubt about our ability to know”. This suggests that uncertainty is a state of mind whereas risk is a state of nature. Uncertainty often results from the absence of information although it may also be due to attitudes toward risk, which differs among individuals. Scholars from many disciplines study how humans behave under conditions of risk and uncertainty. Whereas economists tend to focus solely on the impact of risk on the individual’s quest to maximise satisfaction, psychologists argue that such maximisation is but one factor governing the attitude towards risk. Anthropologists on the other hand place a great degree of reliance in the

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notion that culture influences attitudes towards risk largely by imposing filters through which individuals broadly judge risks as being important or unimportant (Young, 2001: 7-10). Uncertainty includes two elements (De Loach, 2000: 49):

- Whether the event will occur, i.e. likelihood.
- What the outcome of the event will be should it occur, i.e. consequence.

Based on the above, the modern day trend is to interpret risk as the absence of certainty where certainty represents a situation where only one possible outcome exists. Valsamakis is of the opinion that due to the growth and emergence of risk management as a structured discipline, it is vital that earlier definitions of risk are expanded upon so that a consistent approach may be adopted (Valsamakis *et al.*, 2000: 30.).

In a separate research study, the establishment of a standard definition of risk within each organisation is considered one of the key foundations in developing an effective corporate risk management programme (De Loach, 2000: 48).

Below are some of the more recent definitions of risk:

- Uncertain future events that could influence the achievement of a company's objectives (King Committee, 2002: 76).
- Deviation from the expected value (Valsamakis *et al.*, 2000: 35).
- The area of uncertainty surrounding the event (Chong, 2000: 36).
- Any situation where there is uncertainty around which outcome will occur (Harrington *et al.*, 1999:3).
- Denotes the relative variation of the actual from the expected outcome (Skipper, 1998: 6).
- Risks are uncertain future events that could influence the achievement of the organisations strategic, operational and financial objectives. The dimensions of risk include the impact on an organisation's reputation and even the "loss of legitimacy" from activities deemed unacceptable to the community (IFAC, 1999:6).

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- Risk exists when there is uncertainty about the future (Academy for Healthcare Management, 1999:2-2).
- The variation in outcomes around an expectation (Young, 2001: 7).
- Is a concept used to express uncertainty around events and/or outcomes that could have a material effect on the goals of the organisation (McNamee *et al.*, 1998: 2).

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

- Is an uncertainty;
- focuses on future events; and
- affects the achievement of the organisation's goals.

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

*“A concept used to express uncertainty around all possible future events that could significantly influence the achievement of the organisation's business objectives.”*

It is generally accepted that risk should consider all significant eventualities that could have a material effect on the achievement of the organisation's key objectives. Accordingly, risk is most often subdivided into three distinct types. Table 2.2 below lists the three risk types and includes comment on their respective attributes. Practical examples are also included in the table. The following sources were adapted in preparing the table:

- Valsamakis *et al.*, 2000: 39
- IFAC, 1999: 15
- Harrington *et al.*, 1999: 5



Table 2.2: Different risk types

	<i>Risk Type</i>		
	<i>Inherent</i>	<i>Incidental</i>	<i>Systemic</i>
<b>Definition</b>	Risks that have a direct impact on the operating profit of an organisation, i.e. offensive in nature.	Risks that do not form part of the main business operations although they are necessary to ensure continuity of operations, i.e. hedging in nature.	Risks that have no potential for showing a profit, i.e. defensive in nature.
<b>Key Attribute</b>	Opportunity Significant control	Uncertainty/Variance Limited control	Hazard No control
<b>Examples</b>	<ul style="list-style-type: none"> <li>• New member markets</li> <li>• Information systems breakdown</li> <li>• Lack of qualified personnel</li> <li>• Research and development</li> </ul>	<ul style="list-style-type: none"> <li>• Liquidity</li> <li>• Credit</li> <li>• Currency</li> <li>• Interest rate</li> <li>• Inflation</li> <li>• Reputation</li> </ul>	<ul style="list-style-type: none"> <li>• Legislative</li> <li>• Damage to assets</li> <li>• Theft</li> <li>• Legal liability</li> </ul>

It is vital that the communicated definition of risk not only emphasise risk's nature of uncertainty or hazard but also the nature of opportunity (PricewaterhouseCoopers, 2000c). It is accepted that as management migrates from a fragmented to integrated approach, the focus of risk should change to one of maximising opportunity.

**Figure 2.1: Risk progression** (IFAC 1999: 14 & PricewaterhouseCoopers, 2000c)

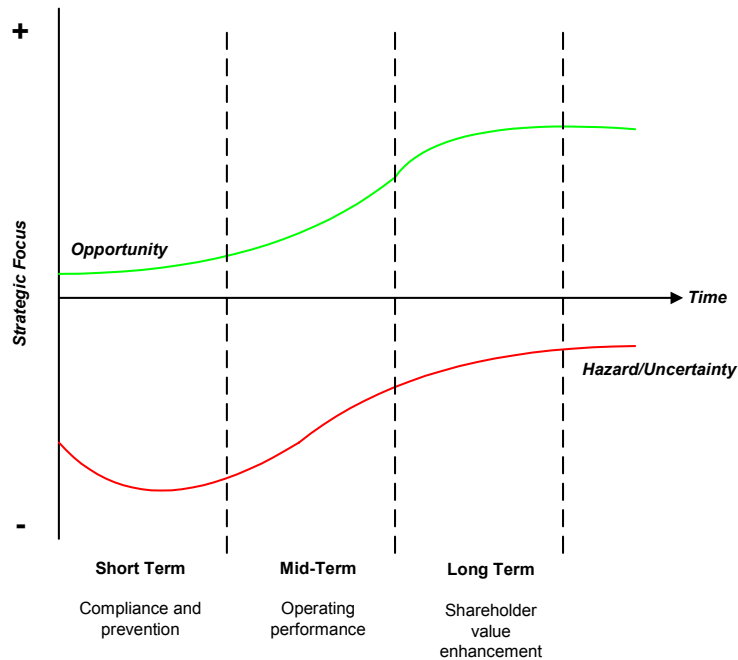


Table 2.3 defines the key natures of risk while figure 2.1 above provides a graphic depiction on how risk's strategic focus changes as management migrates towards corporate risk management.

The following sources were adapted in preparing the table 2.3:

- De Loach, 2000: 49
- PricewaterhouseCoopers, 2000c
- IFAC, 1999: 15

The strategic focus on both elements of opportunity, hazard and uncertainty will drive the choice of risk management strategy that will be applied by the board and management. These risk management strategies are discussed in section 8.5 of chapter 8.

Table 2.3: Natures of risk

<b>Risk Nature</b>	<b>Focus</b>
<b>Hazard</b>	<ul style="list-style-type: none"> <li>• Allocating resources to reduce negative impact and likelihood of events</li> <li>• Financial</li> <li>• Defensive</li> </ul>
<b>Uncertainty</b>	<ul style="list-style-type: none"> <li>• Reducing variances between anticipated outcomes and actual results</li> <li>• Focuses not only on financial issues</li> <li>• Operational controls</li> </ul>
<b>Opportunity</b>	<ul style="list-style-type: none"> <li>• Investment and achieving growth strategy</li> <li>• Offensive in nature</li> <li>• Aims to achieve positive gains</li> </ul>

## 2.7 Summary and conclusion

The beginnings of risk have been traced as far back as 3500BC where the first game of chance was played. The word risk derives from the early Italian *risicare*, which means “to dare”. Since the general term, risk, is found within numerous disciplines ranging from insurance to actuarial science, it is understandable that varying definitions of the term are found.

Although the concept of risk the author shall apply in the remainder of this study focuses on the three key elements of uncertainty, future and the effect on organisation’s goals, the human’s perception of risk is considered to focus on an additional two components, viz. fear and control. How each individual responds to the elements of risk is driven by his perception of loss and gain, cognitive biases and personality. A management ethos that acknowledges the individualistic and variable nature of risk perception and ensures the open discussion of such subjective elements will go a long way in increasing the effectiveness of overall decision making.

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With regard to the philosophy of the risk concept, two positions in the philosophical debate over risk are offered. On one side, positivists believe that risk is a purely scientific concept admitting complete characterisation and analysis through data collection and quantitative methods. Opposed are relativists who believe that risk is a purely subjective reaction to phenomena encountered in personal or social experience. Later developments in the field of philosophy replace relativism with a more contextualist view. In this more contextualist view it is proposed that lay assessments of risk are just as accurate as expert assessments since experts may fail to recognise other dimensions such as voluntariness, which may be more relevant to the points of decision in a given context. Issues relating to risk communication are also discussed.

The following definition for risk is set for the remainder of the study: *A concept used to express uncertainty around all possible future events that could significantly influence the achievement of the organisation's business objectives.*

Risk is unavoidable and present in almost every human intervention. It is present in all person's lives, public and private businesses.

# Chapter 3

## Internal Audit

Corporate risk management is a natural fit for internal auditing involvement. Modern internal auditors are accustomed to identifying and evaluating risks, and they typically have extensive knowledge of the overall business

Walker *et al.*, 2002: 16

### **3.1 Introduction**

To achieve its business objectives, management should ensure that sound risk management processes are in place and functioning. Boards have an oversight role to determine that appropriate risk management processes are in place and that these processes are adequate and effective. Internal auditors should assist both management and the board by examining, evaluating, reporting and recommending improvements on the adequacy and effectiveness of management's risk processes (IIA Standards, 2002).

Rarely are demands for professionalism, knowledge, integrity, and leadership more stringent than those placed on today's internal auditors. Effective auditors serve as the businesses corporate consciousness and they champion operational effectiveness, internal control, and risk management. They can also educate and make recommendations to management and the board of directors to support the business in meeting its goals and objectives.

### **3.2 Aim**

The aim of this chapter will be to introduce internal auditing, its governing body and the role that the activity can play in the corporate risk management initiative of the healthcare financing organisation.

### **3.3 The Institute of Internal Auditors Inc.**

The Institute of Internal Auditors Inc. (IIA) was established in 1941 and serves nearly 85,000 members in internal auditing, governance and internal control, IT audit, education, and security worldwide. The IIA provides for certification, education, research, and technological guidance, it also serves as the profession's watchdog and resource on significant auditing issues around the globe ([www.theiia.org](http://www.theiia.org)).

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In the years preceding the incorporation of the IIA in 1941, growth and expansion made it increasingly difficult for organisations to maintain control and operational efficiency. The shift to a war economy further expanded organisations' responsibilities for scheduling, availability of materials and labourers, compliance with government regulations and an increased emphasis on cost reduction (ibid.).

Management found it impossible to visually observe all of the operating areas in their respective areas of responsibility or to have sufficient personal contact with individuals who directly or indirectly reported to them. In seeking ways to deal with these new problems, management appointed special staff people to review and report on what was happening. These people came to be known as internal auditors (Sawyer *et al.*, 1996).

The internal auditing function varied greatly as to the number of people assigned to perform it and in the scope and nature of the work being done. In some organisations, internal auditors were used to check on routine financial and operational activities with a heavy emphasis on compliance, security, and detection of fraud. In others, internal auditors were given higher levels of status and were asked to analyse and appraise more substantive financial and operational activities. As the profession evolved, a number of internal auditors began pushing vigorously for greater understanding and recognition of their function, and began to develop contacts and relationships with professionals in other organisations in an attempt to share problems and to advance their common interests (ibid.).

John B. Thurston, head of the internal auditing function at the North American Company utility company, was among the first to push vigorously for greater understanding and recognition of the internal auditing function. He is credited with being the person most responsible for the creation of the IIA. Thurston was joined in his thinking by Robert B. Milne, general auditor of the Columbia Engineering Corporation, and Victor Z. Brink, a former auditor and Columbia

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University educator who authored the first major book on internal auditing (www.theiia.org.).

Thurston, Milne, and Brink, acting as an organising committee, contacted 40 friends and associates from the utilities industries, public accounting firms, and other industries, 25 of whom agreed to participate in forming a new organisation for internal auditors. Seventeen individuals attended an organisational meeting on September 23, 1941, at the Williams Club in New York City and agreed to start a new professional organisation for internal auditors. Thurston was appointed interim organising director and Arthur E. Hald of Consolidated Edison Co. was asked to oversee creation of a charter and bylaws (ibid.).

On November 17, The IIA's Certificate of Incorporation was filed which officially established The IIA's name; recognised the IIA as a membership corporation; and identified corporation's specific purposes, which were:

*“To cultivate, promote, and disseminate knowledge and information concerning internal auditing and subjects related thereto; to establish and maintain high standards of integrity, honour, and character among internal auditors; to furnish information regarding internal auditing and the practice and methods thereof to its members, and of other persons interested therein, and to the general public; to cause the publication of articles relating to internal auditing and practices and methods thereof; to establish and maintain a library and reading rooms, meeting rooms, and social rooms for the use of its members; to promote social intercourse among its members; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purpose herein before expressed.”* (ibid.)

The IIA was a national organisation at the outset with several of its 24 original members hailing from both the East Coast and the Midwest of the United States. IIA membership grew to 104 members by the end of the first year, and increased to 1,018 at the end of five years and to 3,700 by 1957, with 20 percent of the latter located outside the United States (ibid.).



The IIA's current mission is to be the primary international professional association, organised on a worldwide basis, dedicated to the promotion and development of the practice of internal auditing. The IIA is committed to (ibid.):

- Providing, on an international scale, comprehensive professional development activities, standards for the practice of internal auditing, and certification.
- Researching, disseminating, and promoting to its members and to the public throughout the world, knowledge and information concerning internal auditing, including internal control and related subjects.
- Establishing meetings worldwide in order to educate members and others as to the practice of internal auditing as it exists in various countries throughout the world.
- Bringing together internal auditors from all countries to share information and experiences in internal auditing and promoting education in the field of internal auditing.

In June of 1999, the IIA's Board of Directors voted to approve a new definition of internal auditing and a new Professional Practices Framework. Both were based on the recommendations of the Guidance Task Force, a special committee of IIA charged with examining the adequacy of current standards and guidance for the practice of internal auditing. The Task Force concluded that a significant gap existed between available guidance and current practice and that a new framework was needed to carry the profession into the 21st century. In order to meet this goal, The IIA has developed the Professional Practices Framework (PPF). In general; the framework provides a structural blueprint of how a body of knowledge and guidance fits together. As a coherent system, it facilitates consistent development, interpretation, and application of concepts, methodologies, and techniques useful to a discipline or profession. Specifically, the purpose of the PPF is to organise the full range of internal audit guidance in a manner that is readily accessible on a timely basis. By encompassing current internal audit practice as well as allowing for

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future expansion, the PPF is intended to assist practitioners throughout the world in being responsive to the expanding market for high quality internal audit services (IIA Standards, 2002).

Throughout the world, internal auditing is performed in diverse environments and within organisations that vary in purpose, size, and structure. In addition, the laws and customs within various countries differ from one another. These differences may affect the practice of internal auditing in each environment. The implementation of the PPF, therefore, will be governed by the environment in which the internal audit activity carries out its assigned responsibilities. No information contained within the PPF should be construed in a manner that conflicts with applicable laws or regulations. If a situation arises where information contained within the PPF may be in conflict with legislation or regulation, internal auditors are encouraged to contact The IIA or legal counsel for further guidance (ibid.)

The Professional Practices Framework consists of three categories of guidance: Standards and Ethics, Practice Advisories, and Development and Practice Aids. The first category (Mandatory Guidance) consists of core materials: the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing (Standards). All mandatory guidance has been submitted for review by the profession through the exposure draft process and is considered to be essential for the professional practice of internal auditing. Other elements of the Framework are linked to these Standards (ibid.).

The purpose of IIA's Code of Ethics is to promote an ethical culture in the profession of internal auditing. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance (ibid.).

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Standards, as described within the PPF, are the criteria by which the operations of an internal audit department are evaluated and measured. They are intended to represent the practice of internal auditing as it should be. The Standards are meant to serve the entire profession of internal auditing, in all types of organisations where internal auditors are found. Within the new framework, the Guidance Task Force called for the development of three sets of standards: Attribute, Performance, and Implementation Standards. The Attribute Standards address the attributes of organisations and individuals performing internal audit services. The Performance Standards describe the nature of internal audit services and provide quality criteria against which the performance of these services can be measured. The Attribute and Performance Standards apply to all internal audit services. The Implementation Standards expand upon the Attribute and Performance Standards, providing guidance applicable in specific types of engagements. These standards ultimately may deal with industry-specific, regional, or specialty types of audit services (ibid.).

Compliance with the concepts enunciated in the mandatory guidance is essential before the responsibilities of internal auditors can be met. As stated in the Code of Ethics, internal auditors shall perform internal audit services in accordance with the Standards. All members of the IIA and all Certified Internal Auditors agree to abide by the Standards and Code of Ethics, and this guidance is intended to be applicable to all members of the internal audit profession, whether or not they are members of the IIA (ibid.).

To be widely applicable, mandatory guidance must necessarily be somewhat generic in nature. Therefore, the PPF includes two additional categories of guidance. Guidance in the second category, the Practice Advisories (formerly known as Guidelines) are strongly recommended and endorsed by The IIA. Although not mandatory, Practice Advisories represent best practices endorsed by the IIA as ways to implement Standards. In part, Practice Advisories may help to interpret the Standards or to apply them in specific internal audit environments. Many Practice Advisories are applicable to all

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internal auditors, while others may be developed to meet the needs of internal auditors in a specific industry, audit specialty, or geographic area. All Practice Advisories are submitted to a formal review process by the IIA's Professional Issues committee or other group designated by the Guidance Planning Committee (ibid.).

The third category of guidance (Development and Practice Aids) includes a variety of materials that are developed and/or endorsed by the IIA. This category includes research studies, books, seminars, conferences, and other products and services related to the professional practice of internal auditing that do not meet the criteria for inclusion in mandatory guidance or Practice Advisories. Development and practice aids can help to implement the guidance offered in the Code of Ethics, Standards, and Practice Advisories. Development and practice aids provide internal audit practitioners with the views of various experts on techniques and processes related to the professional practice of internal auditing (www.theiia.org).

### **3.4 Internal auditing activity**

As mentioned earlier, the IIA redefined internal auditing in June 1999. The revised definition being (IIA Standards, 2002):

*“Internal Auditing as an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”*

The internal auditing profession worldwide is undergoing significant reengineering (Gupta, 2001: 3-5). This reengineering is involving the optimal restructuring of internal audit functions to focus on core and support business processes thereby aiding organisations in achieving their business objectives in risk intelligent ways.

It is generally accepted that this reengineering would involve the following key principles within internal audit (ibid.):

- Fundamental rethinking of internal audit's role in the organisation (i.e. a policeman type role or a value-added strategic partner with management in helping them achieve the organisation's business objectives;
- reestablishment of internal audit's focus in light of the role as defined above;
- redesign of internal auditing processes to align them with the new role and the new focus; and
- redesign of the internal auditing department structure.

According to the proceedings of the First European Internal Auditing Forum organised by KPMG, a reengineered internal auditing function should exhibit many of the following characteristics (ibid.):

- Be able to act as business partners with management or its other customers;
- be a solution-provider rather than service-provider;
- ensure that the culture of the internal auditing department reflects that of the business as a whole;
- ensure that there is a consistency between the charter, objectives, and mission of an internal auditing department and the organisation's mission, and strategic objectives;
- be able to act as agents of change by becoming proactive champions and getting involved in major organisational change;
- understand and concentrate on the business risk management function and be able to link it with corporate priorities;
- be able to act as facilitators for sharing best practices across the entire organisation; and
- be able to develop an internal auditing process capable of positioning the internal audit function to provide a full array of services across the spectrum— from basic compliance audit work to consulting work – while

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ensuring that the internal auditing function delivers seamless service to its customers.

Organisational transformation and the need to do more with fewer resources have thrust risk and control issues to the forefront as never before, the following three excerpts from various publications support this claim:

1. (Editorial 1993)

*“[The changing business environment] has accelerated downsizing and the introduction of new methods such as” empowerment and total quality management.” Layers of middle management have been removed and the hierarchical, bureaucratic approach abandoned... Where does that leave the directors, management, and auditors who have to satisfy themselves and others that an organisation continues to be under control? [We are] in need of a fundamental rethinking of what control is and how it can be achieved?”*

2. (Gibbs et al., 1995: 46)

*“Control environments have been shaken and shifted [in a majority of the business organisations] as a result of downsizing, flattening and decentralisation... Many of the controls on which auditors have traditionally reviewed, such as separation of duties and authorisations, actually tend to work at cross-purposes to the goals of the reengineered, virtual corporation.”*

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(Simon, 1995: 80)

*“A fundamental problem facing managers in the 1990’s is how to exercise adequate control in organisation’s that demand flexibility, innovation and creativity. Competitive businesses with demanding and informed customers must rely on employee initiatives to seek out opportunities and respond to customer needs. But pursuing some opportunities can expose businesses to excessive risk or invite behaviours that can damage a company’s integrity.”*

The above observations are valid because hardly a day goes by when people do not hear or read about an organisation that has been either slapped on the wrist or fined heavily by one or more governmental oversight agencies for failing to protect the interests of its stakeholders. The cost of these control breakdowns is enormous to the companies in terms of “damaged reputations, fines, business losses, missed opportunities, and diversion of management attention to deal with the crisis” (ibid.). Organisations of today now face a whole host of new risks, such as information technology risks, customer information privacy risks, risk related to all aspects of e-commerce, and so forth.

Traditionally, risk was always thought of as financial and compliance in nature by the internal auditor (Gupta, 2001: 54). However in today’s changing environment, the concept of risk has assumed a larger framework. Risk is now perceived in terms of “business” risk rather than only “financial and compliance” risk. Therefore, if this increased risk exposure is not managed effectively with an integrated risk management process, all the gains that have accrued to business organisations could not only potentially disappear, but could also jeopardise the very survival of an organisation.

Financial and compliance controls have been traditionally under the jurisdiction of internal auditors who primarily worked as “policemen” to protect stakeholder value. Proactively speaking, due to their historical involvement in the financial and compliance risks and controls area, who better than the

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internal auditors to help organisations manage these new and unfamiliar business risks? To discharge those broadened functions and increased responsibility diligently, internal auditors need to change their mind set as suggested by Peter M. Senge in his book, *The Fifth Discipline: The Art & Practice of the Leading Organisation* (Senge, 1990: 8). In his book, he describes the importance of organisational learning to survive and compete in today's business environment. And this mind-set change about the role of internal auditing in this new economy will come only by radically reengineering the traditional internal audit approach towards risk and other related activities of the traditionally focused internal audit function.

A more recent trend within the internal audit fraternity is the spearheading of companywide knowledge-sharing efforts by internal auditors. These activities involve the internal audit function assisting management in securing the organisation's understanding of business risk and ensuring the increased awareness of control strategies (Hala, 2002: 32-35):

*"Effective knowledge management is crucial to [corporate risk management], which is predicted on the understanding that business processes, risks, and controls across the organisation are interrelated. Identifying root causes of business risks is part of the foundation of [corporate risk management] because targeting specific root causes helps the organisation use its risk management resources more efficiently.*

*...Nothing in business happens in a vacuum, and rarely do problems occur only once. Mistakes are made, and processes and systems break down. However, a knowledge-sharing initiative led by internal auditing, combined with [corporate risk management] decreases the time it will take for a business to pinpoint mistakes and mitigate risks across the enterprise, and thus, reduces the severity and the scope of those risks."*



### 3.5 Internal auditing of the corporate risk management methodology

An entity's corporate risk management process changes over time. Risk responses that were once effective may become irrelevant; control activities may become less effective, or no longer be performed; or entity objectives may change. This can be due to the arrival of new personnel, changes in entity structure or direction, or the introduction of new processes. In the face of such changes, management needs to determine whether the functioning of each corporate risk management component continues to be effective (COSO, 2003: 79).

Accordingly, the risk management programme should be audited and reviewed periodically, both from an inside and outside perspective. Such an objective assessment should not just include financial and actuarial issues but more importantly whether the risk management programme is achieving its intended vision and associated goals (Young, 2001: 403).

The revised King Report on Corporate Governance recommends that the internal audit activity should not assume the functions, systems and processes of risk management (King Committee, 2002: 76). However, internal audit can play a pivotal role in providing independent assurance regarding the effectiveness of the risk management process within the medical scheme environment. The internal auditor's role in the corporate risk management programme is guided by a selection of local and international standards. Understanding these guidelines will ensure that the internal auditor does not accept responsibilities that could hinder his or her objectivity:

- *IIA Standard 2100: Nature of Work* (IIA Standards, 2002):
  - The internal audit activity evaluates and contributes to the improvement of risk management, control and governance systems.
- *Practice Advisory 2100-3* (IIA Practice Advisories, 2001):
  - Internal auditors should assist both management and the audit committee by examining, evaluating, reporting and recommending

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improvements on the adequacy and effectiveness of management's risk processes.

- Internal audit could act in a consulting role and assist in identifying, evaluating, and implementing risk management methodologies and controls to address risks.
- Developing assessments and reports on the risk management processes is normally a high audit priority.
- Internal audit should identify and evaluate significant risk exposures in the normal course of their duties.
- Internal audit's role in the risk management process may change over time and may be found at some point along a continuum that ranges from:
  - No role, to
  - Auditing the risk management process as a part of the internal audit plan, to
  - Active, continuous support and involvement in the risk management process such as participation on oversight committees, monitoring activities and status reporting, to
  - Managing and coordinating the risk management process.
- Ultimately, it is the role of executive management and the audit committee to determine the role of internal audit in the risk management process.
- Management's view on internal audit's role is likely to be determined by factors such as culture, ability of the internal audit staff and the external environment.
- *King Report on Corporate Governance:*

Under this code, the internal auditor may not be involved in the functions, systems, and processes related to risk management. Their role is simply to assist the board and management in monitoring the said process. Refer to table 7.1 of chapter 7 for more comprehensive information.

Monitoring can be done in two ways: either by means of ongoing activities or separate evaluations. Corporate risk management mechanisms usually are

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structured to monitor themselves on an ongoing basis, at least to some degree. The greater the degree and effectiveness of ongoing monitoring, the less need for separate evaluations by assurance providers such as internal audit functions. The frequency of separate evaluations necessary for management to have reasonable assurance about the effectiveness of corporate risk management is a matter of management's judgment. In making that determination, consideration is given to the nature and degree of changes occurring, from both internal and external events, and their associated risks; the competence and experience of the personnel implementing risk responses and related controls; and the results of the ongoing monitoring (ibid).

In the case of ongoing monitoring, this process is performed on a real-time basis, reacts dynamically to changing conditions, and is ingrained in the entity. As a result, it is more effective than separate evaluations. Since separate evaluations take place after the fact, problems often will be identified more quickly by ongoing monitoring routines. Many entities with sound ongoing monitoring activities nonetheless conduct separate evaluations of corporate risk management. An entity that perceives a need for frequent separate evaluations should focus on enhancing ongoing monitoring activities by "building in" versus "adding on" such activities (COSO, 2003: 81).

While ongoing monitoring procedures usually provide important feedback on the effectiveness of other corporate risk management components, it may be useful to take a fresh look from time to time, focusing directly on corporate risk management effectiveness. This also provides an opportunity to consider the continued effectiveness of the ongoing monitoring procedures (ibid.).

Separate evaluations of the entire corporate risk management programme may be prompted by a number of reasons: major strategy or management change, major acquisitions or dispositions, significant change in economic or political conditions, or significant changes in operations or methods of processing information. When a decision is made to undertake a comprehensive evaluation of an entity's corporate risk management, attention

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should be directed to addressing its application in strategy setting as well as with respect to significant activities (COSO, 2003: 83).

In both approaches, the extent of documentation of an entity's corporate risk management varies with the entity's size, complexity, and similar factors. Larger organisations usually have written policy manuals, formal organisation charts, written job descriptions, operating instructions, information system flowcharts, and so forth. Smaller entities typically have considerably less documentation. Many aspects of corporate risk management are informal and undocumented, yet are regularly performed and highly effective. These activities may be tested in the same ways as documented activities. The fact that elements of corporate risk management are not documented does not mean that they are not effective or that they cannot be evaluated. However, an appropriate level of documentation usually makes monitoring more effective and efficient (COSO, 2003: 85).

Deficiencies regarding the corporate risk management programme usually should be reported not only to the individual responsible for the function or activity involved, but also to at least one level of management above that person. This higher level of management provides needed support or oversight for taking corrective action and is positioned to communicate with others in the organisation whose activities may be affected. Where findings cut across organisational boundaries, the reporting should cross over as well and be directed to a sufficiently high level to ensure appropriate action (COSO, 2003: 86).

Figure 3.1: Suggested objective assessment approach



Figure 3.1 above depicts a suggested objective assessment approach that can be applied by the internal auditor in verifying the effectiveness and efficiency of the risk management process. The following sources were relied upon in developing the suggested process:

- De Loach, 2000
- Discovery, 2001
- IIA Practice Advisories, 2001
- King Committee, 2002
- IIA Standards, 2002.

In assessing the sufficiency and appropriateness of the existing risk management architecture, the internal auditor could attempt to validate the following control objectives:

- The business risk management function has developed a risk management programme that complies with the requirements of governance standards.

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- The board and senior management has sanctioned the developed corporate risk management methodology.
- The following five governance objectives have been achieved (Practice Advisory 2110-1):
  - Risks devolving from the business strategies and activities are identified and prioritised;
  - management and the board have set risk tolerances acceptable to the medical scheme;
  - risk management strategies to address unacceptable levels of residual risk have been established and sanctioned by the board;
  - the risk management process is ongoing to ensure that the effectiveness of controls is revisited; and
  - the board and management receive periodic reports on the results of the risk management process.

Suitable audit procedures, which could be applied by the internal auditor in ascertaining whether the abovementioned control objectives have been achieved by management, include (IIA Practice Advisories, 2001 and COBIT, 2002):

- Review the adequacy and timeliness of reporting on risk management results;
- qualifications of risk management personnel are adequate;
- assess the appropriateness of reporting lines for risk monitoring activities;
- review the completeness of management's risk analysis, actions taken to address issues raised by risk management processes and suggest improvements;
- assimilate information to independently evaluate the effectiveness of risk mitigation, monitoring and communication of risks and associated control activities;
- review previous risk evaluation reports by management and other assurance services;

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- review corporate policies, board and audit committee minutes to determine the organisation's business strategies, risk management philosophy, risk tolerance levels and risk management strategies;
- determine whether operational personnel understand and formally accept residual risk subsequent to each assessment, i.e. – proof of acceptance and sign off;
- risk assessment documentation complies with the adopted risk management methodology and documentation is appropriately prepared and maintained. Such documentation could include:
  - Details on the uniform process adopted and possible reference to the corporate risk management methodology sanctioned by the board;
  - a description of the significant risks linked to individual business objectives;
  - risk scoring criteria and overall prioritisation results subsequent to discounting absolute risk scores with control effectiveness and frequency assessments;
  - heat maps graphically depicting high, moderate and low threats; and
  - risk action plans detailing appropriate risk management strategies to be used in eliminating unacceptable levels of residual risk. Acceptance of residual risk should take into account the approved risk management tolerances set by the business risk committee and board.

If the internal auditor is of the opinion that the risk management process has deficiencies, an appropriate finding should be raised in his audit report (IIA Practice Advisories, 2001). This feedback should also be forwarded to the chief risk officer for improvement in the existing risk management processes.

On a final note, internal audit activities are beginning to place reliance on the output of existing risk management activities as a basis for determining auditable entities within the organisation. A trend, which the author believes will increase.

### **3.6 Summary and conclusion**

The author introduces the concept of internal auditing and the background regarding its professional governing body, viz. The IIA. The IIA was established in 1941 and serves nearly 85,000 members in internal auditing, governance and internal control, IT audit, education, and security worldwide. In June of 1999, the IIA's Board of Directors voted to approve a new definition of internal auditing and a new Professional Practices Framework.

With respect to the internal auditor's role in the risk management process, simply stated, it is to provide objective feedback on whether the risk management process is rigorous enough to ensure that the plethora of risks faced by healthcare administration organisations is being suitably managed.

The bulk of an entity's risks relate to selecting strategies and objectives, establishing operational goals and accountabilities, allocating funds among projects and business segments, minimizing exposure to loss of reputation or creditability and making optimal uses of technology to manage the entity. Consequently, the enhancement of internal auditor's traditional assurance role on both financial and non-financial areas, as well as the expansion of its assessment, process improvement and related consulting activities is a logical complement to the business's broad risk management initiative. Accordingly, it is necessary that the internal audit activity increase its service offerings to management, the board and the entity's other stakeholders.



# 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

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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

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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

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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

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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

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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

<i>Criteria</i>	<i>Initial</i>	<i>Repeatable</i>	<i>Defined</i>	<i>Managed/Optimising</i>	
	<i>Awareness</i>		<i>Risk Management</i>		<i>Corporate Risk Management</i>
<i>Capabilities</i>	<ol style="list-style-type: none"> <li>1. Risk identification</li> </ol>	<ol style="list-style-type: none"> <li>1. Common risk language adopted</li> <li>2. Dedicated risk management resources</li> <li>3. Risk management policy</li> <li>4. Risk drivers identified</li> </ol>	<ol style="list-style-type: none"> <li>1. Uniform risk management process</li> <li>2. Roles and responsibilities defined</li> <li>3. Risk management policy followed by all</li> <li>4. Risk measurement</li> <li>5. Consistent risk reporting</li> <li>6. Risk management tolerances initiated</li> </ol>	<ol style="list-style-type: none"> <li>1. Enterprise wide task strategies</li> <li>2. More objective risk measurement</li> <li>3. Integrated risk management systems</li> <li>4. Risk measures integrated with business performance and incentives</li> <li>5. Continuous feedback</li> </ol>	
<i>Benefits</i>	<ol style="list-style-type: none"> <li>1. Risk awareness</li> </ol>	<ol style="list-style-type: none"> <li>1. Improved business knowledge</li> <li>2. Uncertainties evaluated</li> <li>3. Risk-reward decisions receive more attention</li> <li>4. More effective risk-based decision making</li> </ol>	<ol style="list-style-type: none"> <li>1. Risk anticipated better than competitors</li> <li>2. Linkage between risk management and line operations management</li> <li>3. Improved capital and resource allocation</li> <li>4. Risk transparency with stakeholders</li> </ol>	<ol style="list-style-type: none"> <li>1. Capitalise on market opportunities</li> <li>2. Risk managed as integral part of business management</li> <li>3. Risks aggregated to reduce risk transfer costs</li> <li>4. Risk management integrated with business planning strategy</li> </ol>	

Continued...

<i>Criteria</i>	<i>Initial</i>	<i>Repeatable</i>	<i>Defined</i>	<i>Managed/Optimising</i>
	<i>Awareness</i>		<i>Risk Management</i>	
	<i>Corporate Risk Management</i> 			
<i>Methods used</i>	<ol style="list-style-type: none"> <li>Undefined roles and responsibilities</li> <li>Reliance on specific personnel to initiate</li> </ol>	<ol style="list-style-type: none"> <li>Common risk language</li> <li>Quality people assigned</li> <li>Defined tasks</li> <li>Initial risk management architecture implemented</li> </ol>	<ol style="list-style-type: none"> <li>Process uniformly applied across the firm</li> <li>Rigorous methodologies and processes institutionalised</li> </ol>	<ol style="list-style-type: none"> <li>Intensive debate on risk/reward trade-off issues</li> <li>Best practice, continuous benchmarking ongoing</li> <li>Emphasis on exploiting risk</li> </ol>
<i>Focus</i>	<ol style="list-style-type: none"> <li>Financial risk</li> </ol>	<ol style="list-style-type: none"> <li>Financial and hazard risks and internal controls</li> </ol>	<ol style="list-style-type: none"> <li>Risk</li> </ol>	<ol style="list-style-type: none"> <li>Risk</li> </ol>
<i>Scope</i>	<ol style="list-style-type: none"> <li>Chief Financial Officer</li> </ol>	<ol style="list-style-type: none"> <li>Treasury, insurance and operations involved</li> </ol>	<ol style="list-style-type: none"> <li>Business managers accountable (fragmented approach)</li> </ol>	<ol style="list-style-type: none"> <li>Optimal alignment and integration of resources organisation-wide</li> </ol>
<i>Linkage to opportunity</i>	<ol style="list-style-type: none"> <li>Understated</li> </ol>	<ol style="list-style-type: none"> <li>Understated</li> </ol>	<ol style="list-style-type: none"> <li>Is clearer</li> </ol>	<ol style="list-style-type: none"> <li>Seamless integration</li> </ol>

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:

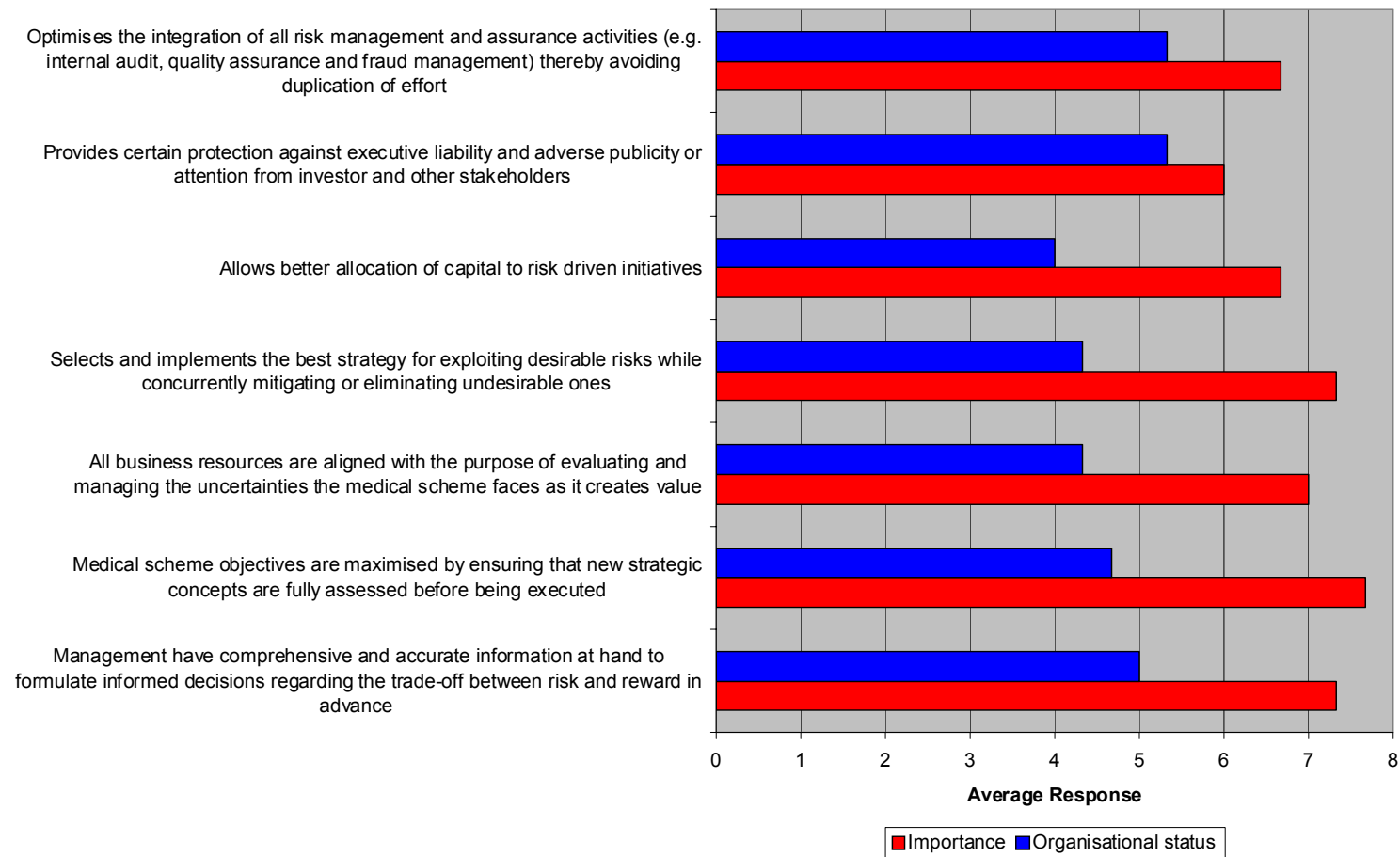
<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
<i>Organisational Status</i>	>8 = Managed/optimised.....7.....6 = defined.....5.....4..... 3 = repeatable.....2.....1 = initial/rudimentary
<i>Difficulty in Implementing</i>	>8 = 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**

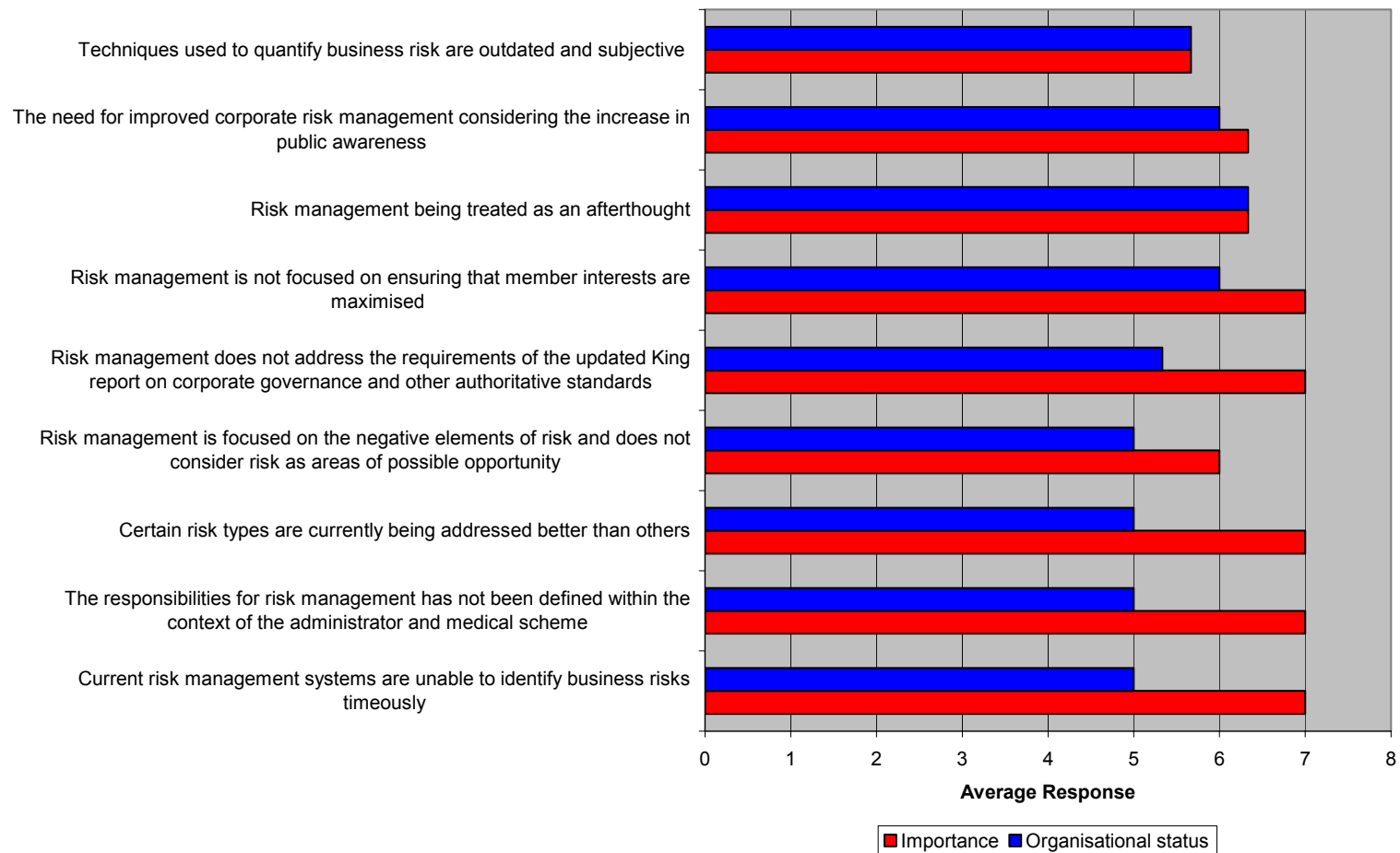
*What improved benefits arise from a corporate risk management programme and how are these being addressed within the organisation?*





**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.

# Chapter 5

## Private Healthcare

With health insurance becoming more expensive, it becomes more difficult to address problems such as expanding coverage for the uninsured and providing prescription drugs for seniors

USA Today, 2002: 8A

Medical schemes are non-profit organisations and their main objective is to assist members with their medical expenses

Da Costa, 2000:56

## **5.1 Introduction**

Before the author embarks on establishing what risks South African medical aids face, it is necessary that an understanding of the background and workings of the medical scheme environment be obtained.

De Beers Consolidated Mines initiated private healthcare administration in 1889. After the Second World War, the existence of such schemes had increased to a stage where, by 1960, there were 169 schemes providing cover to 1.5 million lives (Davies, 1995: 3). By 1980, this number had increased to 289. These increasing trends are in stark contrast to the 145 medical schemes currently registered with the Council of Medical Schemes in South Africa (Da Costa, 2000: 67). Reasons for this dramatic decline were alluded to in chapter 1.

## **5.2 Aim**

The aim of this chapter will be to:

- Provide insights into the status of private healthcare in the United States and Europe;
- introduce the concept of medical schemes and how such activities are governed in South Africa; and
- present empirical survey results relating to the South African private healthcare environment.

### 5.3 United States and Europe

#### 5.3.1 United States

47% of healthcare costs in the United States are covered by state and federal reimbursement under Medicare and Medicaid programmes (Vaughn *et al.*, 1999: 375).

Medicare is a social insurance programme primarily for those over 65 or disabled whereas Medicaid is a needs-based programme for the poor. Virtually all persons over the age of 65 are covered under the Medicare programme. It is estimated that approximately 60% of Medicare covered persons purchase additional private healthcare cover to supplement their Medicare cover (*ibid.*).

Roughly, 85% of persons under the age of 65 are covered by private health insurance, usually by an employer-sponsored plan. The private healthcare industry is composed of three broad types of service providers (Vaughn *et al.*, 1999: 375-376):

- *Commercial insurance companies:* There are approximately 1200 insurance companies that sell health insurance, providing around 78 million persons with hospital and surgical expense benefits. This includes 38 million persons covered under fully insured group plans and 7 million persons covered under individual policies. These commercial insurance companies comprise property and liability insurers, life insurers and dedicated health insurers.
- *Blue Cross and Blue Shield:* These associations are usually organised under special state enabling legislation to provide for prepayment of hospital and surgical expenses. The Blue Cross plans were originally organised by individual hospitals to permit and encourage prepayment of hospital expenses. Blue Shield plans occupy the same position in the surgical expense field that Blue Cross plans occupy in the

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hospitalisation field. Together they insure an estimated 67.1 million persons.

- *Capitating healthcare providers:* Capitating healthcare providers include health maintenance organisations and physician hospital organisations or provider sponsored organisations. Health maintenance and provider sponsored organisations differ from commercial insurers in that they are also healthcare providers. The insurance element in their operations derives from the manner in which they charge for their services, which is called a capitation. Under the capitation approach, individual subscribers pay an annual fee and in return receive a wide range of healthcare services.

A recent trend in the United States is a growing number of group health insurance plans are being self-ensured by major employers. This is often done to reduce the extent of associated costs. Cost advantages stem from two major sources. Firstly, by eliminating the premium, the employer eliminates the premium taxes assessed by the government and secondly, most states request that group insurance policies include certain prescribed benefits. Self-insured plans are exempt from these mandated benefits requirements (ibid.).

Regarding the status of the healthcare in America, the following excerpts appeared in a United States newspaper:

1. (USA Today, 2002: 8A)

*“On average, workers paid 27% more toward their insurance premiums and 16% more for family health coverage, according to a survey of more than 3000 companies by the non-profit Kaiser Family Foundation.*

*...‘we expect costs to rise at higher rates for the next several years,’ says Altman...‘With health insurance becoming more expensive, it becomes more difficult to address problems such as expanding*



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*coverage for the uninsured and providing prescription drug coverage for seniors,' says Altman."*

2. (USA Today, 2003: 4A)

*"More than 1 million low-income Americans have lost or might lose government-subsidised health care as states try to contain rapidly escalating costs.*

*The cuts and potential reductions represent 2% of the 47 million Americans who receive Medicaid, the federal-state health care program for the poor and disabled. Last year, Medicaid cost \$250 billion, up 13.4% from 2001."*

**Table 5.1: Distribution of Health-Insured Population** (Vaughn *et al.*, 1999: 377)

<b>Population</b>	<b>Persons insured (Millions)</b>	<b>% of population</b>
Commercial insurance companies	78	29
Blue Cross and Blue Shield	67	25
Self Insured Plans	62	23
Capitating Health Care Providers	60	22
Medicare	38	14
Medicaid	38	14

The private healthcare environment in the United States faces two main problems, viz. access to healthcare and cost (Vaughn *et al.*, 1999: 394-400):

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- *Access to healthcare:* It is estimated that over 40 million Americans have no medical aid coverage. The majority of these persons are poor. Their plight is compounded by the fact that poverty accentuates poor health and poor health in turn often breeds poverty.

The problem of access is not only limited to the economically disadvantaged. It also exists for persons who, because of personal hazards, are unable to obtain health insurance in the standard marketplace. Plans for small employers may exclude coverage for certain employees and persons who must purchase insurance individually often find that they cannot obtain it. It is estimated that this equates to 3 percent who have no medical aid coverage.

Finally, access to healthcare is also a concern for residents of rural areas where the issue is not of a financial nature but rather the absence of healthcare facilities. Many rural areas lack doctors and hospitals and residents must travel to cities to receive essential care.

- *Healthcare costs:* The following factors are listed as being responsible for the upward trend in increased healthcare costs in the United States:
  - *Aging population:* Since people are living longer, increased costs for healthcare are evident.
  - *Excessive capacity:* Although advances in medical technology create justifiable increases in cost, they can also be a source of waste and inefficiency.
  - *Defensive medicine:* The increasing litigious atmosphere of the United States, evidenced by an epidemic of malpractice suits, encourages physicians to practice defensive medicine, an inclination that compounds the impact of technology on costs. Advances in technology create increasingly expensive testing equipment with vastly expanded diagnostic powers. The threat of

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malpractice suits strengthens the physician's inclination to use the equipment to perform more and higher-cost diagnostic testing.

- *Insurance-encouraged utilisation*: Highlights the built-in tendency for people to use more healthcare services when insured.
- *Cost-shifting*: When government plans (viz. Medicare and Medicaid) attempt to control costs by reducing the amounts they pay to providers, the providers must compensate by increasing the fees they charge others. This cost-shifting concept is one reason why the cost of private healthcare insurance has increased so rapidly.
- *Mandated benefits*: All states in the United States have passed laws mandating medical aids to cover certain medical expenses to providers. These mandated benefits tend to increase the cost of medical aid coverage.

To address the two main struggles of access and cost, the United States is considering the following solutions (ibid.):

- *Single payer plan*: Under this approach, a country-wide system for comprehensive health insurance would be funded by taxes and administered by a federal agency. It would eliminate the need for medical aids and provide a substitute that would allow benefits for hospital, dental, optometric, home and nursing care. The federal agency would establish a national budget for healthcare and set fees paid to providers.
- *Employer-mandated health insurance*: Under this approach, employers would be required to provide healthcare to their employees or to pay payroll tax that would help fund benefits provided by a government programme. The plans typically require the employer to pay only a certain percentage of the premiums for employees. Those not receiving insurance from their employer may be required to purchase insurance either individually or from the government programme.
- *Individual mandates*: This approach places the burden for the purchasing of health cover on the individual. Those who could not

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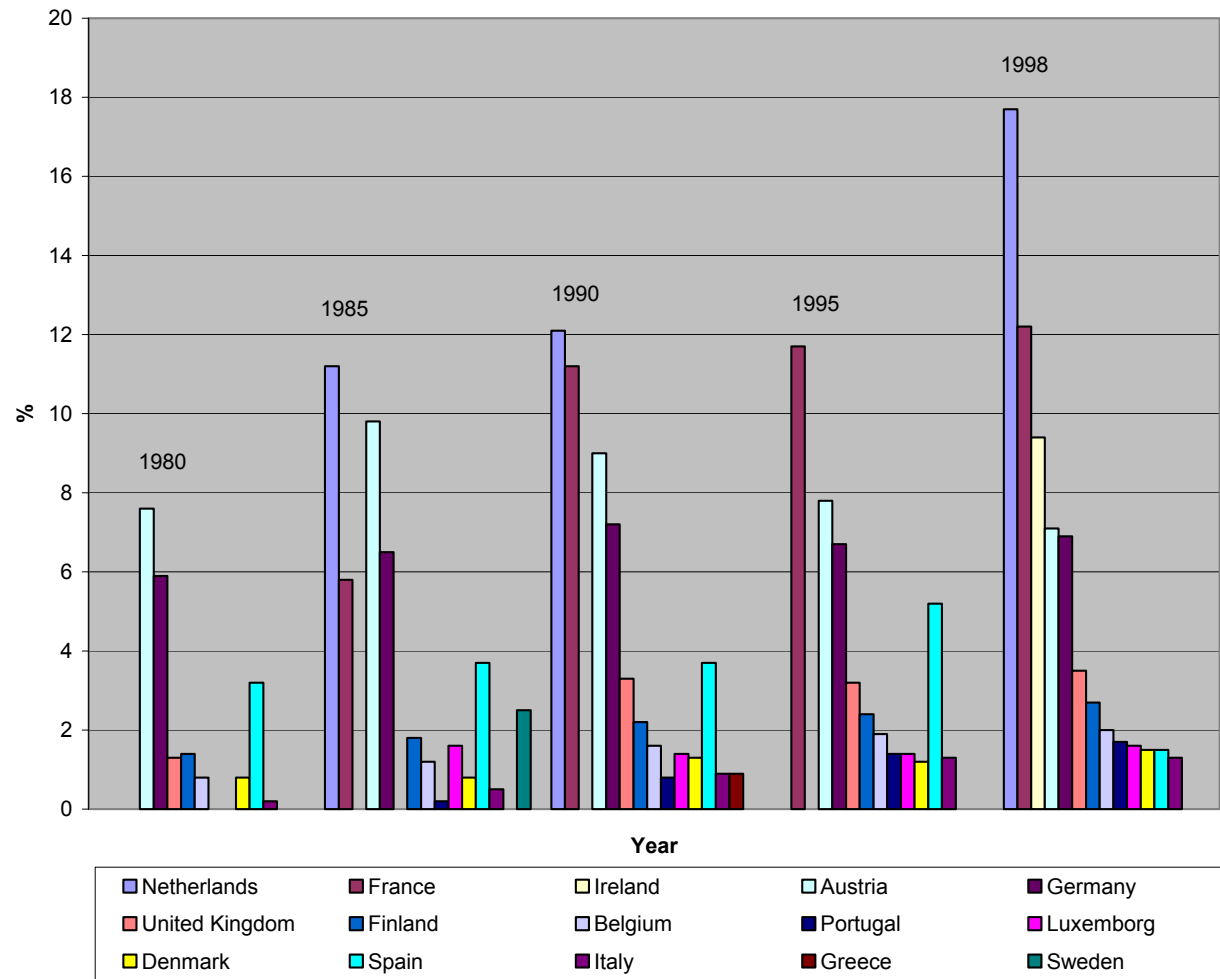
afford health insurance would be eligible for tax credits to subsidise the cost. Many individuals prefer this approach to a national healthcare system, as it retains individual choice and responsibility.

### 5.3.2 Europe

Private health insurance does not play a dominant role in the European Union as it does in the Americas. For largely historical reasons, governments in Europe have aimed to preserve the principle of healthcare funded by the state (Mossialos *et al.*, 2002: 128).

Figure 5.1 provides information on the extent of European private healthcare as a percentage of total health expenditure for the period 1980-98.

Figure 5.1: European private healthcare spend as a percentage of total health expenditure (Mossialos *et al.*, 2002: 132)



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Private healthcare plans are classified as substitutive, supplementary or complementary (Mossialos *et al.*, 2002: 19):

- *Substitutive*: Most healthcare systems in Europe are mainly financed through taxation or contributions from employees and employers. This means that participation in the statutory healthcare system is usually mandatory. In Germany, the Netherlands and Spain, however, certain groups of people are either not covered by the statutory healthcare system or are allowed to abstain from joining. This leaves them free to purchase voluntary health insurance as a substitute for statutory protection.
- *Complementary*: This type of plan provides full or partial cover for services that are excluded or not fully covered by the statutory healthcare system.
- *Supplementary*: Supplementary health insurance increases consumer choice and access to different healthcare services, guaranteeing superior accommodation and amenities and more crucially, faster access to treatment, especially in areas of healthcare with long waiting lists. This type of plan is often referred to as double coverage and is especially prevalent in Greece, Italy, Portugal, Spain and the United Kingdom.

Table 5.2 provides details on the percentage of population covered by voluntary health insurance within the various countries of the European Union. It is interesting to note that the distribution of coverage for private healthcare in many of the European countries is heavily skewed in favour of consumers with high incomes (Mossialos *et al.*, 2002: 136).

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**Table 5.2: Percentage of population covered by voluntary health insurance<sup>2</sup>**  
(Mossialos *et al.*, 2002: 133)

<b>Country</b>	<b>%</b>
Luxembourg	75
France	53
Ireland	42
Belgium	30
Netherlands	29
Denmark	28
Finland	22
Spain	17.6
Austria	17
United Kingdom	11.5
Portugal	10
Greece	10
Germany	9
Italy	5
Sweden	0.5

The following excerpt relates to the European Union's regulatory control framework that oversees insurance plans such as voluntary health schemes (Mossialos *et al.*, 2002: 135):

<sup>2</sup> Combined results for substitutive, complementary and supplementary health plan types.

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*“The European Commission has issued directives leading to the creation of a single market for life and non-life insurance within Europe. The third non-life insurance directive adopted by national law in July 1994 abolished national controls on premium prices and prior notification of policy conditions for voluntary health plans.*

*The European Union’s approach to the creation of a single market, based on liberalisation and substantial deregulation, demonstrates its concern for the financial viability of voluntary health insurers rather than consumer protection. Given the market failures inherent in voluntary health insurance, it could be argued that relying primarily on market mechanisms may not be the best way of delivering cost-effective and competitively priced voluntary health insurance products.”*

The author concludes by stating that he believes increased regulatory developments are necessary to ensure that the European Union market works more efficiently and allocates resources in a more equitable manner (ibid.).

**5.4 The business of a medical aid scheme**

The purpose of a medical aid scheme is found in section 1 of the Medical Schemes Act No. 131 of 1998:

*“Business of a medical scheme” means the business of undertaking liability in return for a premium or contribution-*

- *To make provision for the obtaining of any relevant health services;*
- *to grant assistance in defraying expenditure incurred in connection with the rendering of any health service; and*
- *where applicable, to render a relevant health service, either by the medical scheme itself or by any supplier or group of suppliers of a relevant health service or by any other person, in association with or in terms of an agreement with a medical scheme.*

Medical aid coverage works on the basic principles of insurance and pays for the services received by members and dependents from practitioners of their choice (Da Costa, 2000: 56). The scheme pays for the cost of medical care within prescribed



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benefits. Providers are paid for services rendered with medical schemes effectively guaranteeing payment to providers on condition that they charge in accordance with these predefined benefits (Da Costa, 2000: 68). Certain other concepts unique to the medical scheme environment are included in table 5.3.

Medical schemes in South Africa are classified as either open or closed. Open schemes allow members from the public to join and are thus not restricted in terms of membership. Larger companies normally establish closed schemes. Membership is restricted to employees or members of such companies. Of the 145 medical schemes registered with the Council of Medical Schemes as at January 2002, 35% were classified as open ([www.medicalschemes.com](http://www.medicalschemes.com)). Figure 5.2 depicts the top 20 open medical schemes for 1999 based on the number of average lives covered.

**Figure 5.2: Top 20 open medical schemes** (Financial Mail, 2000: 368):

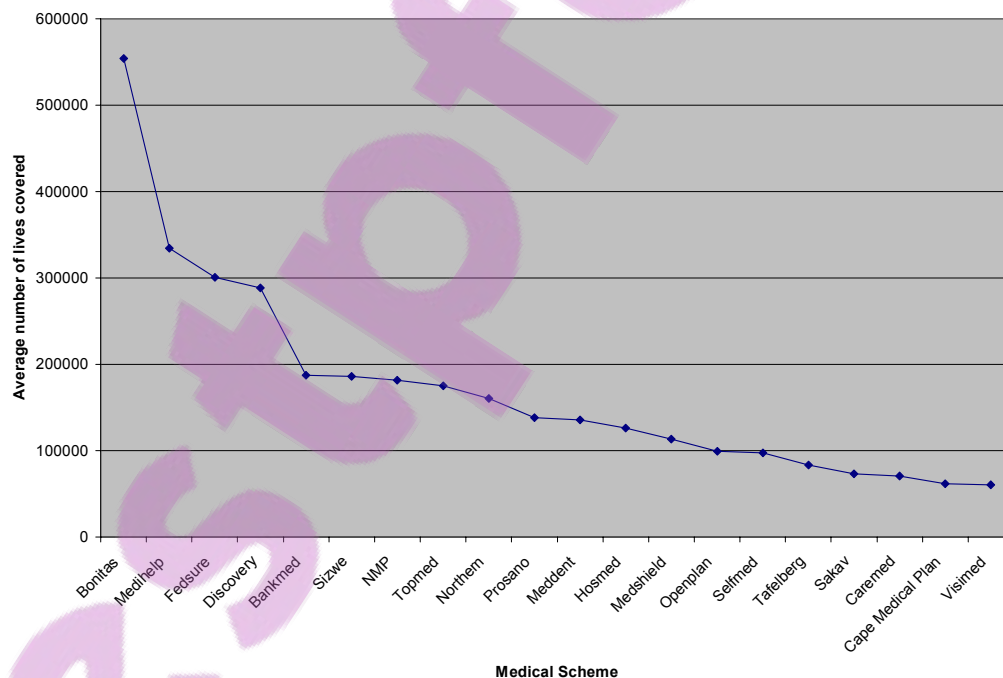


Table 5.3: Medical scheme concepts

<b>Concept</b>	<b>Explanation</b>
<i>Board of Trustees</i>	Persons charged with managing the affairs of a medical scheme and which have been elected or appointed under the fund rules (Medical Schemes Act, 1998).
<i>Medical scheme fund rules</i>	<p>Rules, constitutions and/or agreements, in terms of which the member receives healthcare benefits and in terms of which the fund is administered (SAICA, 2001). This includes (Medical Schemes Act, 1998):</p> <ul style="list-style-type: none"> <li>• The provisions of the law, charter, deed of settlement, memorandum of association or other documents by which the medical scheme is constituted;</li> <li>• the articles of association; and</li> <li>• provisions relating to the benefits and contributions received.</li> </ul>
<i>Member</i>	A natural person, admitted to membership of a fund who is entitled to healthcare benefits, in terms of the rules of the fund, in exchange for a contribution (SAICA, 2001).
<i>Healthcare benefits</i>	The entitlement to healthcare services that a member has in terms of the rules of the fund (SAICA, 2001).

Continued...

<b>Concept</b>	<b>Explanation</b>
<i>Savings plans</i>	<p>Certain funds provide for member savings plan account facilities to assist the members in (ibid.):</p> <ul style="list-style-type: none"> <li>• managing cash flow for costs to be borne by members during the accounting period by;</li> <li>• self funding their out of hospital expenditure; and</li> <li>• meeting or self-funding member co-payments for provider services rendered.</li> </ul>
<i>Managed care</i>	<p>Involves capitation contracts through which the utilisation of health care is monitored and efficiency, quality and cost effectiveness of the delivery of relevant health services is managed (ibid).</p>
<i>Claims incurred</i>	<p>An amount, net of discount, payable to the provider or the member for healthcare benefits supplied to the member, in terms of the rules of the fund (SAICA, 2001).</p>
<i>Reinsurance</i>	<p>A fund, in order to spread its risk, may re-insure defined risks. Reinsurance is aimed at protecting the administrator of the medical scheme against insolvency or possible significant losses which it itself cannot effectively address by means of self-insurance (Pickford, 2000: 262).</p>

Continued...

<b>Concept</b>	<b>Explanation</b>
<i>Solvency requirements</i>	Regulation 29 of the Regulations to the Medical Schemes Act of 1998 requires that the scheme maintain accumulated funds, expressed as a percentage of gross annual contributions. As alluded to in chapter 1, medical aid schemes are required to attain a solvency level of 13.5% of contributions by the end of 2001. By the end of 2002, schemes have to reach a solvency level of 17.5% (Du Preez: 2001).

The demand for private healthcare is driven by the following conditions: (Mossialos *et al.*, 2002: 136):

- Consumer demand for such cover exists;
- the cover may be provided at a price that the individual is willing to pay; and
- external factors such as the countries financial environment technically permits the provision of such a service.

In addition to the abovementioned conditions, the following high-level considerations will usually influence the success of a medical scheme (*ibid*):

- The ongoing monitoring of the state of health of the covered population;
- the ongoing monitoring of the magnitude of loss when illness does occur;
- changes to the level of taxes and subsidies provided by government and the employer; and
- changes in the level of income and education of the consumer.

Figure 5.3 depicts the business functions incorporated within a conventional healthcare administration organisation. Each of the functions is assigned to a business category of overall governance, core, support or assurance. The following sources were consulted in preparing the representation:

- Academy for Healthcare Management, 1999
- De Loach, 2000

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- Discovery, 2001
- Council of Medical Schemes, 2001
- Harrington *et al.*, 1999
- Financial Mail, 2000
- Hymans, 2001
- SAHR Study, 2000a
- SAHR Study, 2000b

To support figure 5.3, respondents to the empirical study were requested to indicate whether any significant functions were omitted. No additional functions were cited. Details on the activities performed within each of the functions are elucidated upon in table 5.4.

Figure 5.3: Functions within the administration organisation

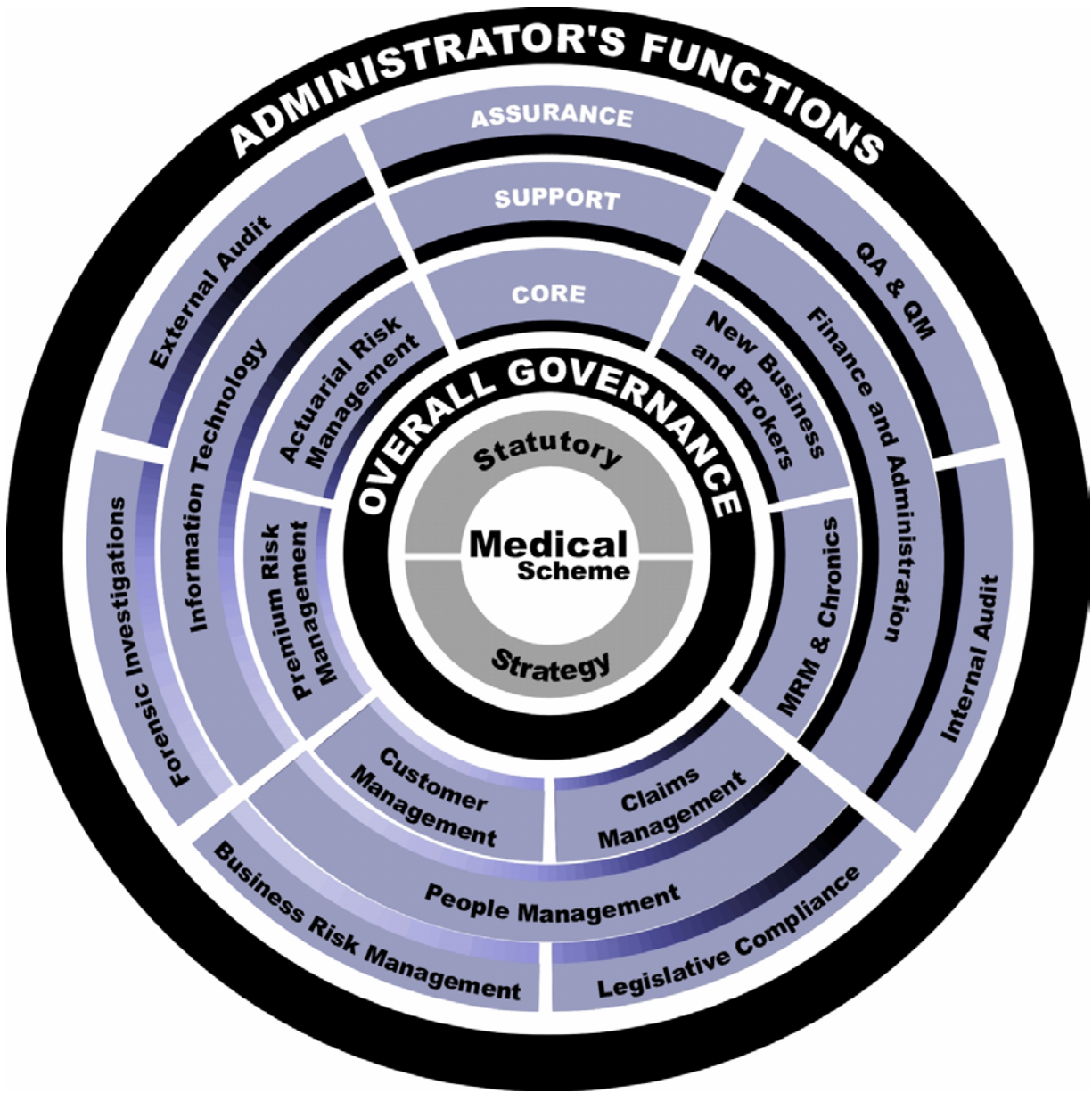


Table 5.4: Key activities performed within each of the functions

<i>Type</i>	<i>Function</i>	<i>Key activities</i>
<i>Overall governance</i>	Strategy	Research and development and long-term strategic planning
	Statutory	Trustee responsibilities and legislative compliance management
<i>Core</i>	Actuarial Risk Management	Forecasting and actuarial functions
	Premium risk management	Collection of premiums and debtor management
	Customer management	Call centre and customer relationship initiatives
	Claims management	Claims payments and assessing
	Medical risk management and chronic benefits	Pre-authorisation of hospital take-ins and chronic medication applications
	New business and brokers	New member take-on and broker management
<i>Support</i>	Finance and administration	Regular financial reporting and administration
	People management	Staff utilisation optimisation and succession planning
	Information technology	Key support systems and systems development

Continued...

<i>Type</i>	<i>Function</i>	<i>Key activities</i>
<i>Assurance</i>	Quality assurance or management	Daily monitoring and feedback of key transaction processes
	Internal audit	Objective assessment of risks
	External Audit	Statutory reporting review and auditing
	Forensic investigations	Fraud detection and prevention
	Risk management	Proactive risk management assistance and coaching
	Legislative compliance	Objective coordination of compliance with the Medical Schemes Act and other associated legislation

### 5.5 Roles and responsibilities of governing bodies

In 1993, the state president, Mr FW de Klerk, appointed a Commission of Inquiry into the manner in which medical expenses were being provided for. The commission was chaired by the Honourable Mr Justice Melamet and had as members Professor WD Reekie and Mr CC van der Meulen. The issues investigated by the commission were (Davies, 1995:8):

- The funding of schemes;
- the insurance industry's involvement in the healthcare cover industry; and
- the role of intermediaries in medical schemes.

The most significant recommendation from the commission was to give greater power to the Registrar of Medical Schemes to acquire information timeously and to inspect the financial records of a medical scheme (ibid).



The first Medical Schemes Act that was promulgated in 1967 survived a number of amendments until 1998 (SAHR, 2000a). The issues addressed by the current Medical Aid Schemes Act No. 131 of 1998 include (Medical Schemes Act, 1998):

- Establishment of the Council of Medical Schemes as a juristic person;
- to provide for the appointment of the Registrar of Medical Schemes;
- to make provision for the registration and control of medical scheme activities; and most importantly
- to protect the interests of the members of medical schemes.

According to the abovementioned Act, the Council of Medical Schemes is established to ensure compliance with the said Act and associated regulations. The broad functions of the Council, which convene at least 4 times annually, includes (ibid.):

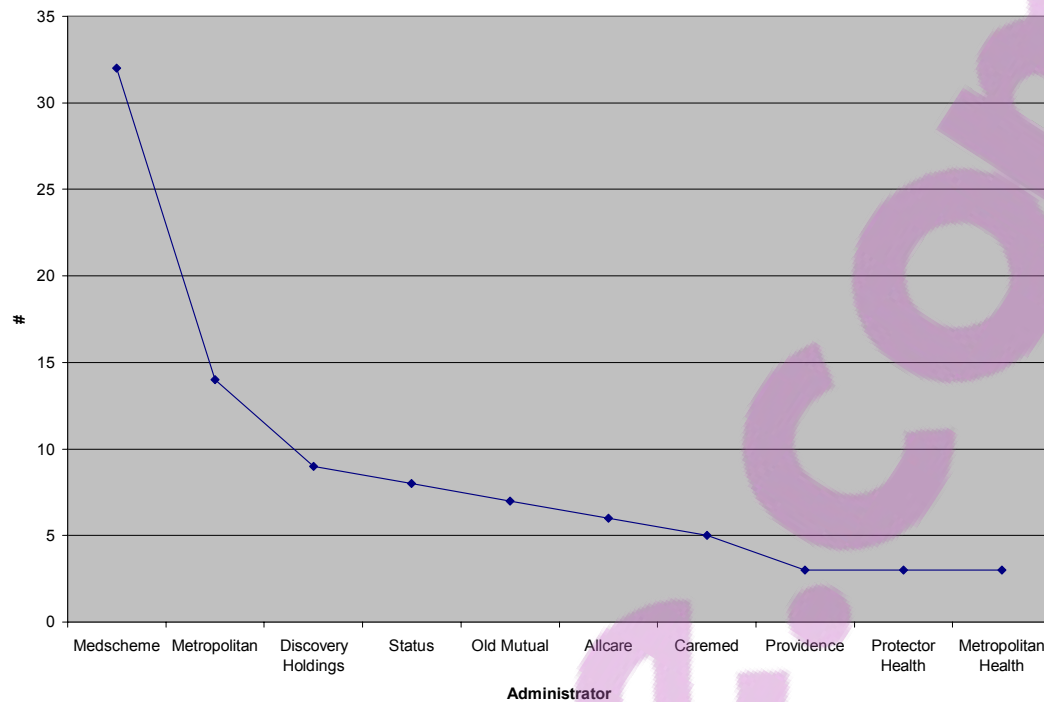
- Protect the interests of members at all times;
- control and coordinate the functioning of medical schemes in a manner that is complementary with the national health policy;
- make recommendations to the Minister of Health on criteria for the measurement of quality and outcomes of the relevant health services provided for by the medical schemes and such other services as the Council may, from time to time, determine;
- investigate complaints and settle disputes in relation to the affairs of medical schemes as provided for in the Act;
- collect and disseminate information regarding private healthcare;
- implement rules, not inconsistent with the provisions of the Act, for the purpose of the performance of its functions and the exercise of the Council's powers;
- advise the Minister of Health on any matter concerning medical schemes; and
- perform any other functions conferred on the Council by the Minister or by the Act.

The Council receives funding from government, levies from medical schemes and other sources such as fines and interest on overdue levies.

### **5.6 Roles and responsibilities of medical scheme administrators**

A medical scheme has a board of trustees that is responsible for the management and overall governance of the fund. In accordance with section 57(1) of the Act, every fund is to have a board of trustees consisting of persons who are fit and proper to manage the business. Below are key guidelines from the Act regarding the role of trustees (Medical Schemes Act, 1998):

- At least 50% of the members of the board of trustees are to be elected from amongst the members of the fund. A person who is a director or an employee of the third party administrator of a fund is not allowed to be a member of the board of trustees of that fund.
- The duties and responsibilities of the board of trustees are set out in sections 57(4) and 57(6) of the Act. These include ensuring that proper registers, books and records of all operations of the fund are kept and that proper internal control systems are employed by or on behalf of the fund.
- In accordance with section 37(1) of the Act, the board of trustees is to cause annual financial statements to be prepared and is to submit copies thereof, together with the report of the board of trustees, to the Council within four months after the end of the accounting period.
- In accordance with section 37(5) of the Act, the trustees are to prepare a report that deals with every matter, which is material for the appreciation by members of the fund, of the state of affairs and the business of the fund.
- Responsible for establishing an audit committee as required in section 36 of the Act.

**Figure 5.4: Top 10 administration organisations** ([www.medicalschemes.com](http://www.medicalschemes.com)):

The trustees of the medical scheme will either create an administration organisation or delegate the full administration function to a specialist company (Davies, 1995:4). The specialist administration company should only have responsibilities in respect of general administration and should not assume any of the functions of the trustees (Davies, 1995:4). Figure 5.4 depicts the number of medical schemes administered by the top 10 specialist administration organisations registered with the Council of Medical Schemes as at January 2002.

In return for providing administration services, the administration organisation will charge a fee. These costs include but are not limited to (SAICA, 2001):

- fees and disbursements paid or payable to the trustees;
- fees and disbursements paid or payable to a third party fund administrator for the administration of the fund;
- other contracted services that are not of a claims nature;

- administration and consulting contracts with advisors;
- actuarial valuations and legal fees;
- depreciation;
- lease rentals;
- interest paid on finance leases;
- association fees;
- fees and disbursements to the auditors;
- fidelity guarantee and professional indemnity insurance premiums, and
- penalties.

Section 58 of the Medical Schemes Act No. 131 of 1998 and Chapter 6 of the associated regulations govern the roles and responsibilities of the private healthcare administrator. The key responsibilities covered by the regulations include (Regulations, 1999):

- Agreement in respect of administration;
- termination of administration agreements;
- appointment of external auditors;
- indemnity and fidelity guarantee insurance;
- maintenance of financial soundness; and
- dissolution or liquidation of business.

To ensure that members' interests are protected, the Council of Medical Schemes initiated a process to promote the formal accreditation of administrators (Council of Medical Schemes, 2001). A draft guideline on such requirements was issued in 2001. In August 2002 a follow-up circular indicating that the Council had finalised the process of soliciting proposals in terms of which administrators would be accredited under the Medical Schemes Act and regulations was issued (Council of Medical Schemes, 2002). The panel chosen to conduct the evaluation and assessment of the infrastructure of administrators consists of a joint venture amongst the Council for Health Service Accreditation of Southern Africa, KPMG Consulting and

SB&T Incorporated. The evaluation process to be conducted by this joint venture entails (ibid.):

- The setting up of audit mechanisms, standards and criteria for accreditation.
- Conducting a pilot study at a medium sized administrator.
- Developing and finalising the process for application and assessment of all administrators.
- Provision of questionnaires to administrators and subsequent on site visits at administration facilities to verify submitted information.
- Evaluation of administrator performance in terms of the standards and criteria.
- Submission of a detailed report by the panel on whether accreditation should be given to the administrator or not.
- An ongoing assessment of established criteria against international best practice.

### **5.7 Statutory financial reporting**

Medical schemes are required to produce audited financial statements each year. Their financial year runs from the 1<sup>st</sup> of January to the 31<sup>st</sup> of December. The audited statements and certain statistical information must be supplied to the Council of Medical Schemes. The Council utilises all audited financial statements that are received as well as associated information to prepare their annual report, which is publicly available (Davies, 1995: 6).

As was noted in chapter 1, more rigorous auditing and accounting guidelines on medical schemes was issued by the South African Institute of Chartered Accountants in February 2001 (Hymans, 2001). To assist in implementing and continuously improving these guidelines, the Institute convened a Medical Schemes Project Group comprising appropriate representation from ([www.isaca.org](http://www.isaca.org)):

- The external auditing profession;
- the medical schemes industry;
- the regulators of medical schemes; and
- the actuarial profession.

The aims of the project group include (ibid):

- The enhancement of the quality and effectiveness of:
  - Financial reporting by medical schemes;
  - the audits of medical schemes;
  - the risk management process in medical schemes; and
  - corporate governance in the medical schemes industry.
- To assist in the development of audit and accounting pronouncements for medical schemes.
- To assist in the development of continuing professional education for members and associates involved in the medical schemes industry.

The financial statements of a medical fund should fairly present the financial position of the fund, changes in funds and reserves, the results of its operations and cash flows for the accounting period. The appointed external auditor of the medical scheme is required to verify the fair presentation (SAICA, 2001).

In view of the complex nature of an audit of a medical scheme, the auditor may obtain assurance from a variety of audit techniques. These include tests of control and tests of detail of transactions and balances, including analytical procedures and review procedures. It may also involve other auditors and the use of experts. The auditor exercises judgement in determining the most effective combination based on the information available, the deemed risks and materiality. The combination of procedures should ensure sufficient evidence is gathered to address the audit assertions of completeness,

occurrence, existence, measurement, valuation, rights and obligations, and presentation and disclosure (ibid.).

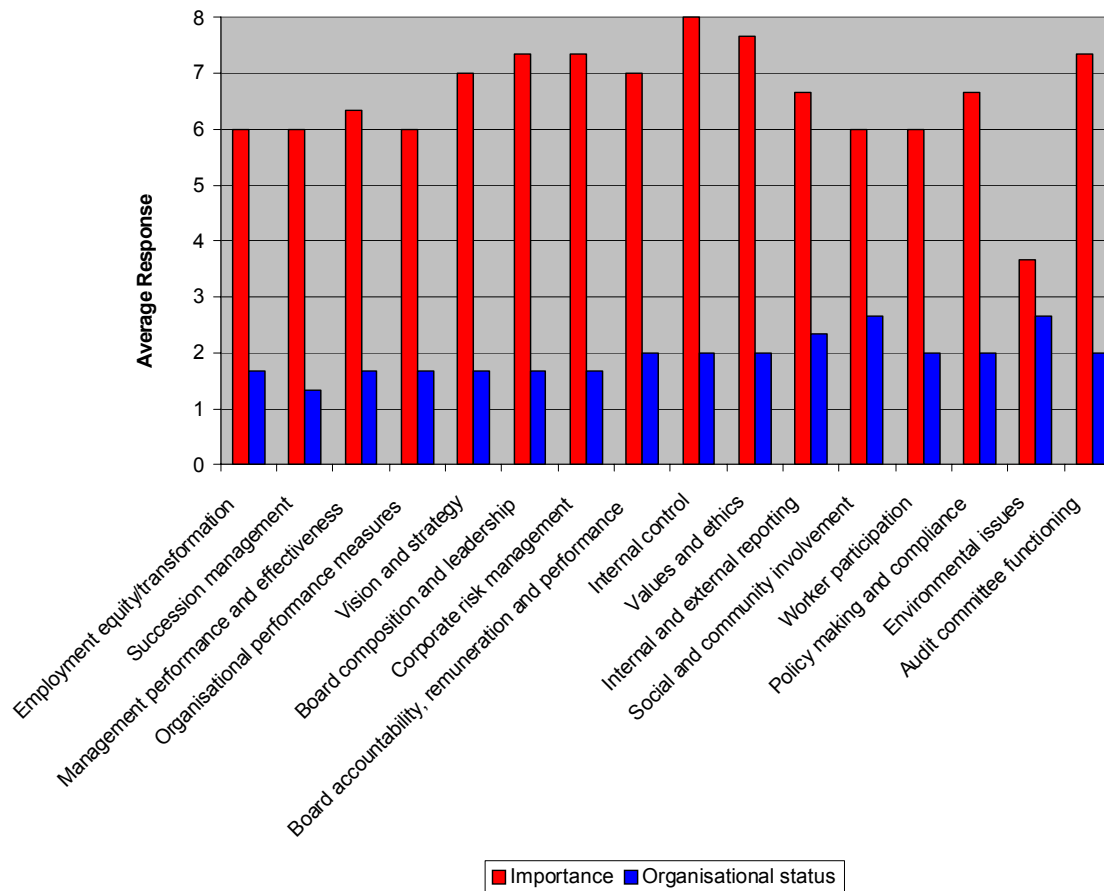
### 5.8 Empirical survey results

Scales applied in the empirical study were as follows:

<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
<i>Organisational Status</i>	>8 = Managed/optimised.....7.....6 = defined.....5.....4..... 3 = repeatable.....2.....1 = initial/rudimentary
<i>Difficulty in Implementing</i>	>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

**Figure 5.5: Empirical study results: corporate governance**

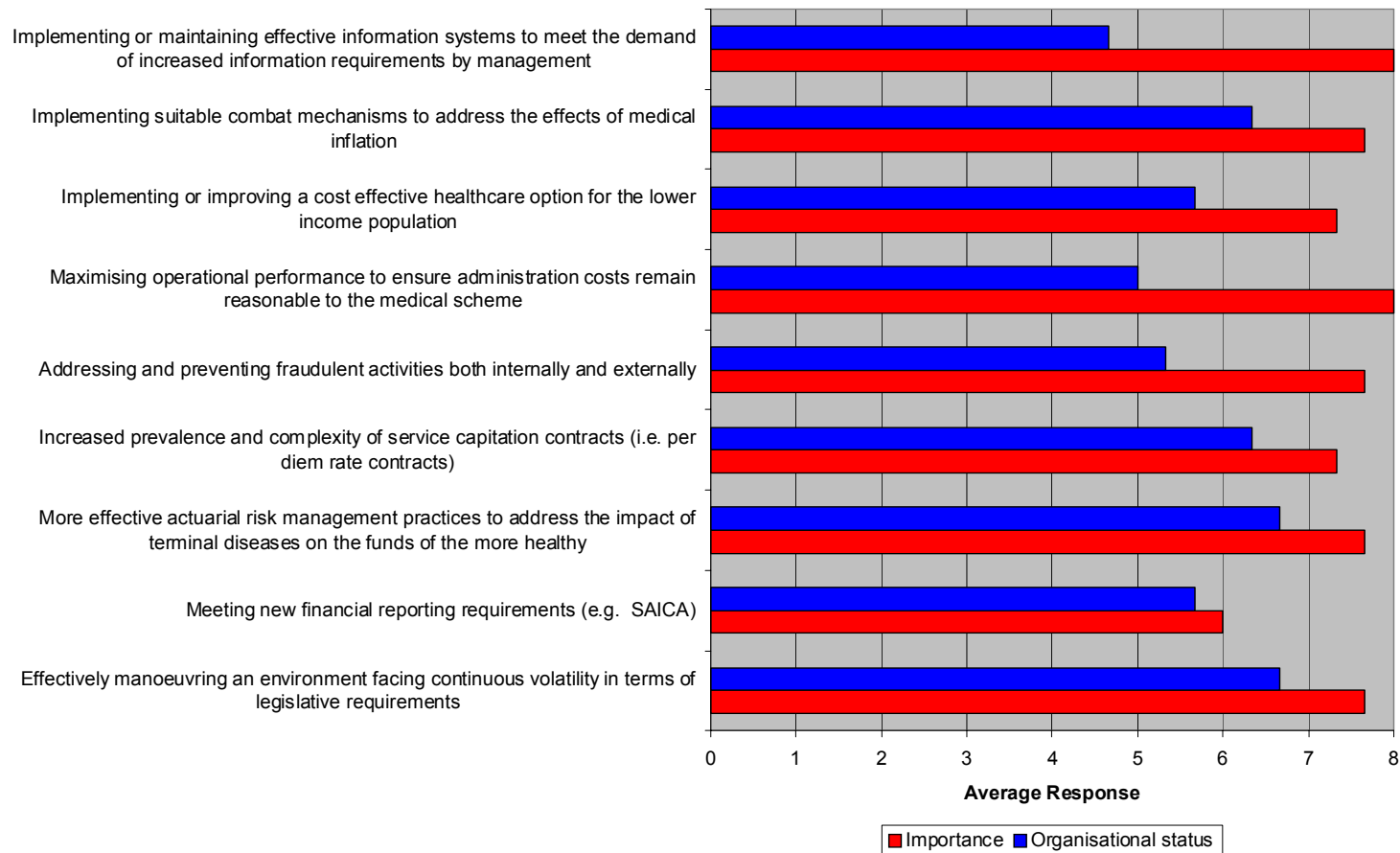
*With regard to the various components of corporate governance, assign levels of importance to such components relating specifically to the medical scheme and indicate how well they are being managed*



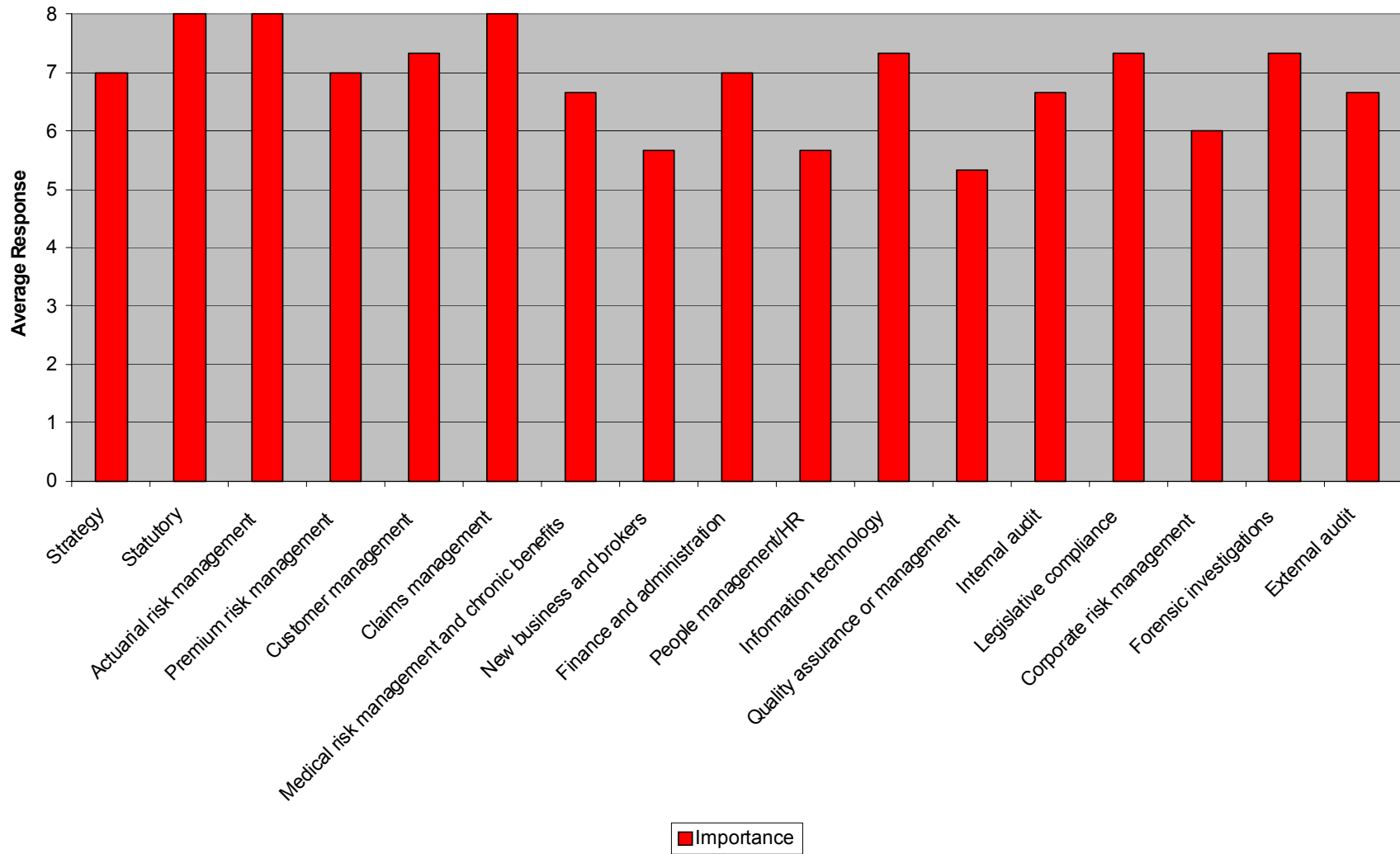


**Figure 5.6: Empirical study results: pressing issues**

*Which of the following factors are considered the most pressing issues facing the medical scheme environment and how well are they being addressed?*

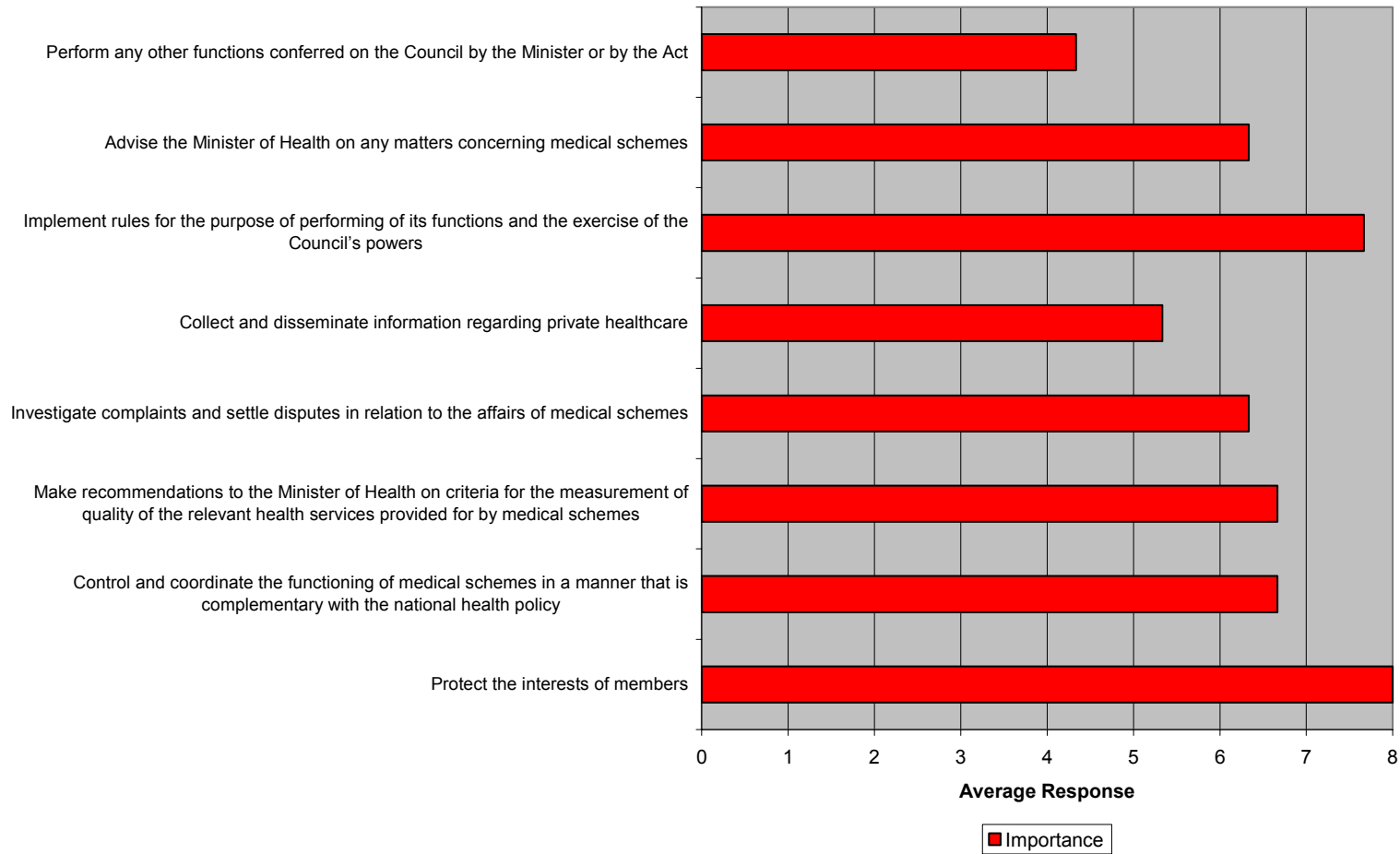


**Figure 5.7: Empirical study results: importance of functions**



**Figure 5.8: Empirical study results: functions of the Council**

*Which of the following functions of the Council of Medical Schemes are considered important?*



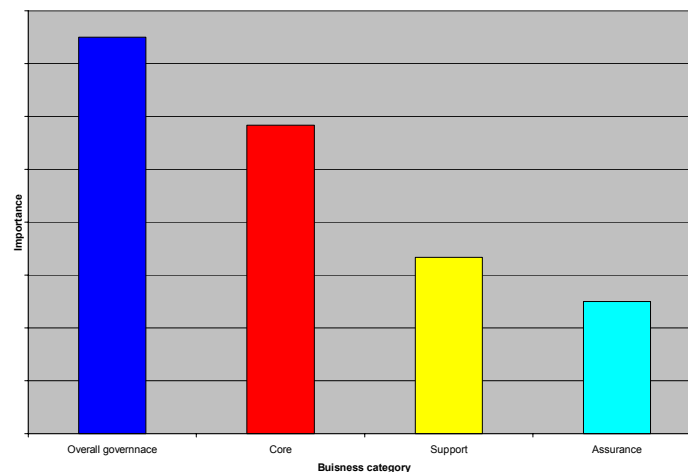
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Based upon the responses detailed in figures 5.5 to 5.8, the following observations apply:

- Values and ethics, internal control, corporate risk management and audit committee functioning are identified as the most significant corporate governance issues facing healthcare administration organisations today. Of these criteria, respondents indicated that they were being poorly managed within their organisations.
- Information systems and the maximising of operational performance to inhibit administration costs are identified as the most pressing issues facing medical schemes. As will be noted later, these concerns and any other high-risk issues can be effectively managed through a corporate risk management programme.
- The individual business functions of statutory, actuarial risk and claims management are identified as the most critical within the healthcare administration organisation.

Figure 5.9 depicts the results of consolidating the individual business functions of figure 5.3 into the four business categories of overall governance, core, support and assurance.

**Figure 5.9: Empirical study results: prioritised business categories**



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Figure 5.9 confirms that overall governance, which consists of the statutory and strategy elements, is of paramount importance in today's medical scheme environment. Organisations require effective business plans, participative boards of trustees and senior management teams to ensure the survival of their organisations.

Comments included in the King Report on Corporate Governance in South Africa support claims that strategic initiatives and operational activities (also known as core) should be the most focused upon risk categories in all industries (King Committee 2002: 78):

*“Circumstances demanding close attention would include substantive changes to the operating environment, new personnel, new or revamped information systems, rapid growth, new technology, new products or activities, corporate restructuring, acquisitions and disposals”*

- Implementing governing rules and ensuring a member's interests are protected are identified by respondents as the top 2 functions of the Council of Medical Schemes.

**5.9 Summary**

Insights from the private healthcare environment in the United States and Europe are provided. The most noteworthy of these being:

- 47% of healthcare costs in the United States are covered by state and federal reimbursement programmes.
- 23% of the United States population utilise private healthcare or medical scheme plans to complement state and federal reimbursement programmes.
- The United States population has experienced an average 27% increase in the cost of medical scheme plans. It is expected that this increasing trend will continue for several years to come.

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- The private healthcare environment in the United States faces two main problems, viz. access to healthcare and cost.
- Private healthcare plans in Europe are subdivided into substitutive, complementary and supplementary plans.
- The European country utilising the highest degree of private healthcare plans was Luxemburg (75% of population) while Sweden utilised the least (0.5% of population).
- The country with the highest private healthcare spend, as a percentage of total health expenditure for 1998, was the Netherlands while Austria was the lowest.

This chapter introduces the primary aim of the medical scheme as the business of undertaking liability in return for a premium or contribution by a member to make provision for the receiving of any relevant health services by that member.

The Council of Medical Schemes was introduced as the governing body of all medical schemes in South Africa. Legislation governing the South African medical schemes environment is encompassed in the Medical Aid Schemes Act No. 131 of 1998 and its associated regulations.

In certain instances, the board of trustees responsible for the activities of the medical scheme may decide to outsource the administration activities to a specialist organisation. Such an organisation, often termed the administration company, will take responsibility for the general administration and not any fiduciary responsibilities in terms of managing or governing the scheme.

The following significant issues are identified from the empirical study conducted:

- Values and ethics, internal control, corporate risk management and audit committee functioning are identified as the most significant corporate governance issues facing healthcare administration organisations.

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- Information systems and the maximising of operational performance to inhibit administration costs are identified as the most pressing issues facing medical schemes.
- Governance and core activities were identified as the two most significant risk categories within medical schemes.
- Implementing governing rules and ensuring that a member's interests are protected are identified as the top two functions of the Council of Medical Schemes.

**5.10 Conclusion**

As can be seen from the information included in Chapter 1 and the research detailed above, medical schemes throughout the world are a risky business. These organisations are required to provide exceptional cover to consumers whilst retaining costs in a highly regulated environment. This is no easy task and requires that risks be managed proactively so that suitable assurance may be provided to stakeholders that their funds and benefit provisions are safe.

The next chapter will focus on identifying the types of medical scheme risks prevalent within the South African medical aid organisation.

# Chapter 6

## Medical Scheme Risks

When business fails to distinguish  
the long-term effects of gradual  
changes, it displays the classic  
'boiled frog' syndrome

*Sunter et al., 2002*

Risk identification seeks to  
pin down all risks facing the business

*Pickford, 2001: 55*



## **6.1 Introduction**

In the most general sense, any activity undertaken by a business entails some form of risk and ultimately every risk has the potential to impact the business (Academy for Healthcare Management, 1999: 2-5).

Accepting risk is a key business function and a vital part of the private healthcare administrator's activities. It also involves managing those risks to ensure that members interests are protected and that suitable benefits are provided to members at reasonable cost.

Before the author embarks on defining a suitable risk management methodology it is necessary to understand the risks faced by today's medical schemes.

## **6.2 Aim**

Issues to be addressed in this chapter are the establishment of a plausible definition for risk and identifying the most significant risks encountered by medical schemes in South Africa.

Relevant results from the empirical study will be relied upon to substantiate findings.

### **6.3 Risks faced by the private healthcare administration organisation**

Various sources were consulted in preparing a list of probable risks facing the medical scheme environment, which would be assessed as part of the empirical study conducted. These sources included:

- Academy for Healthcare Management, 1999
- Discovery, 2001
- Council of Medical Schemes, 2001
- Harrington *et al.*, 1999
- Financial Mail, 2000
- Hymans, 2001
- SAHR Study, 2000a
- SAHR Study, 2000b

To ensure completeness, respondents to the empirical study were requested to indicate whether any risks were omitted and required assessment. No additional risks were cited.

**Table 6.1: Scales applied in prioritising risks**

<b>Scale</b>	<b>Consequence</b>	<b>Description</b>	<b>Scale</b>	<b>Likelihood</b>	<b>Description</b>
<b>5</b>	Catastrophic	Close of business unit	<b>5</b>	Almost certain	Event will occur at an unknown future date
<b>4</b>	Major	Extensive loss of production time	<b>4</b>	Likely	Significant chance that event will occur
<b>3</b>	Moderate	Lost production time	<b>3</b>	Possible	Good chance that associated event will occur
<b>2</b>	Minor	Slowed business processes. Impact on future business growth	<b>2</b>	Unlikely	Risk has been identified but event highly unlikely to occur
<b>1</b>	Insignificant	Business as usual. Management takes note and will still implement controls	<b>1</b>	Rare	May only occur under exceptional circumstances

Risks prioritised in figure 6.1 were assessed based upon two criteria, viz. consequence and likelihood. These criteria are defined as:

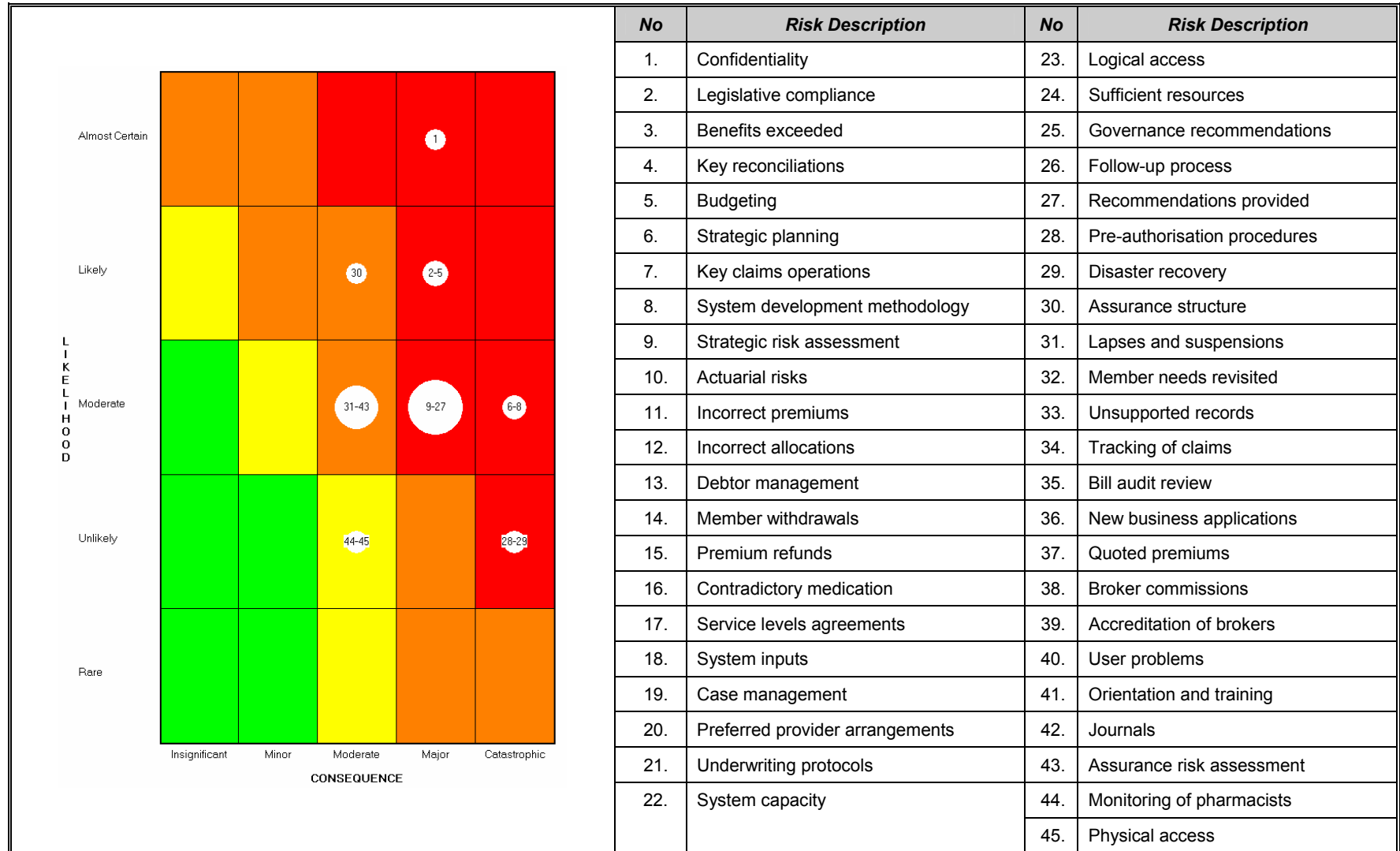
- *Consequence*: The financial loss and sustainability of key operations in the event of the risk being realised.
- *Likelihood*: The likelihood of the risk occurring.

A description of the scales applied in determining the results of figure 6.1 is included in table 6.1. It is important to note that scores exclude the effectiveness and frequency of internal controls in place within the respective organisations that participated in the empirical study.

Table 6.2 provides a description of the risks detailed in figure 6.1 and their associated categories. Section 8.3.2 in chapter 8 provides guidance on the most common types of risks and processes which are encountered in a

healthcare financing organisation. The risk framework suggested in figure 8.1 of chapter 8 was relied upon in setting up the empirical study questionnaire.

Figure 6.1: Empirical study results: prioritised individual risks



**Table 6.2: Prioritised risk descriptions and associated categories**

<b>No</b>	<b>Risk Category</b>	<b>Risk Description</b>	<b>Details</b>
1.	Strategy and Statutory	Confidentiality	Unauthorised personnel have access to financial/medical information.
2.	Strategy and Statutory	Legislative compliance	Control mechanisms to ensure compliance with governing legislation are not in place.
3.	Medical risk management and chronic benefits	Benefits exceeded	Members exceed their benefit allowances.
4.	Finance and Administration	Key reconciliations	The finance department does not reconcile or follow-up outstanding items on reconciliations between all systems and the general ledger on a frequent basis.
5.	Finance and Administration	Budgeting	No formal budgeting system in place and monitoring of expenses ongoing.
6.	Strategy and Statutory	Strategic planning	Senior management have not taken responsibility in developing long to short-range business plans that will allow the medical scheme's mission and goals to be achieved.
7.	Claims management	Key claims operations	Performance in terms of key claims operations are inadequate.
8.	Information technology	System development methodology	The existing system development methodology does not address all key control areas expected within a systems development environment.
9.	Strategy and Statutory	Strategic risk assessment	Management has not established its own systematic risk assessment framework that is applied on a consistent basis.

Continued...

No	Risk Category	Risk Description	Details
10.	Actuarial risk management	Actuarial risks	<p>The following 5 criteria are not considered in actuarially based calculations:</p> <ul style="list-style-type: none"> <li>• <i>Asset risk</i>: The risk of adverse fluctuations in the value of assets.</li> <li>• <i>Underwriting risk</i>: The risk that premiums will not be sufficient to pay for services or claims.</li> <li>• <i>Credit risk</i>: The risk that providers and plan intermediaries paid through reimbursement methods that require them to accept utilisation risk will not be able to provide the services contracted for and the risk associated with recoverability of the amounts due from reinsurers.</li> <li>• <i>Business risk</i>: The general risk of conducting business including the risk that actual expenses will exceed amounts budgeted.</li> <li>• <i>Economic risk</i>: The risk that is inherent to the South African economy for e.g. the Dollar/Rand exchange rate fluctuations, and interest rate fluctuations.</li> </ul>
11.	Premium risk management	Incorrect premiums	Incorrect premiums charged to members.
12.	Premium risk management	Incorrect allocations	<p>Premiums received are not correctly allocated resulting in:</p> <ul style="list-style-type: none"> <li>• Members receiving none/inadequate benefits.</li> <li>• High incidences of client queries and dissatisfaction.</li> </ul>
13.	Premium risk management	Debtor management	<p>Outstanding debtors are not properly managed in terms of:</p> <ul style="list-style-type: none"> <li>• Ageing of debtors</li> <li>• Reconciliations</li> <li>• Follow-up of debtors and tracing accounts</li> </ul>
14.	Premium risk management	Member withdrawals	Member withdrawal debt (claw back) is not proactively managed and followed-up resulting in high cost to the scheme in terms of debt collection and legal costs.
15.	Premium risk management	Premium refunds	Incorrect or unauthorised premium refunds resulting in loss of income for the scheme.

Continued...

<b>No</b>	<b>Risk Category</b>	<b>Risk Description</b>	<b>Details</b>
16.	Medical risk management	Contradictory medication	Suitable checks are not conducted to ensure that medicines applied for are not in contradiction with one another.
17.	Customer management	Service levels agreements	Non-achievement of service level agreements and customer expectations in terms of: <ul style="list-style-type: none"> <li>• Call centre management</li> <li>• Provider relations</li> <li>• Marketing initiatives</li> <li>• Public relations and reputation management.</li> </ul>
18.	Claims management	System inputs	Inadequate system input standards are not in place.
19.	Medical risk management	Case management	Lack of concurrent and retrospective case management.
20.	Premium risk management	Preferred provider arrangements	Lack of understanding and application of preferred provider arrangements.
21.	New business and brokers	Underwriting protocols	Underwriting of new members not compliant with Medical aid rules.
22.	Information technology	System capacity	The non-measurement and ongoing monitoring of system capacity resulting in key applications being unavailable.
23.	Information technology	Logical access	Uncontrolled logical access to systems may result in unauthorised admittance to confidential data.
24.	People management	Sufficient resources	Sufficient human resources are not in place to achieve business objectives.
25.	Strategy and Statutory	Governance recommendations	The scheme does not address existing corporate governance standards and other oversight body recommendations.
26.	Assurance	Follow-up process	No formalised process in place whereby follow-up occurs on reported items to management.
27.	Assurance	Recommendations provided	No formalised assurance services process to provide recommendations to management on weaknesses identified.

Continued...



<b>No</b>	<b>Risk Category</b>	<b>Risk Description</b>	<b>Details</b>
28.	Medical risk management	Pre-authorisation procedures	Incorrect pre-authorisation procedures when loading in-hospital events.
29.	Information technology	Disaster recovery	Failure to continue business activities in case of a disaster, as a result of a lack of a disaster recovery plan.
30.	Assurance	Assurance structure	Assurance services do not address existing corporate governance standards and other oversight body recommendations.
31.	Premium risk management	Lapses and suspensions	Lapses and suspensions are not followed-up timeously resulting in losses for the scheme.
32.	Medical risk management	Member needs revisited	Suitable monitoring controls are not in place to assess the member's needs for chronic medication on a regular basis.
33.	New business and brokers	Unsupported records	Not all members loaded are supported by an authorised application form.
34.	Claims management	Tracking of claims	Lack of controls with regards to collection and insufficient tracking procedures of claims.
35.	Medical risk management	Bill audit review	Insufficient bill audit review process.
36.	New business and brokers	New business applications	New business applications are not distributed to all outbound activities and service in a timely manner.
37.	Premium risk management	Quoted premiums	Premiums quoted disagree to actual premiums charged.
38.	New business and brokers	Broker commissions	Performance in terms of key broker commissions operations is inadequate.
39.	New business and brokers	Accreditation of brokers	No accreditation process for brokers.

Continued...

<b>No</b>	<b>Risk Category</b>	<b>Risk Description</b>	<b>Details</b>
40.	Information technology	User problems	Loss of productivity due to user problems not being addressed timeously.
41.	People management	Orientation and training	Appropriate orientation and ongoing training is not provided to set/maintain the knowledge and skills of all personnel.
42.	Finance and Administration	Journals	Adjusting journals and journal descriptions are not controlled and the necessary authorisation is not obtained.
43.	Assurance	Assurance risk assessment	Assurance services have not established their own systematic risk assessment framework that is consistently applied.
44.	Medical risk management	Monitoring of pharmacists	Little/No controls in place to effectively monitor the decisions made by pharmacists.
45.	Information technology	Physical access	Uncontrolled access to the high risk IT premises may result in damage to company resources.

Based on the results included in figure 6.1 and table 6.2, the individual risks of confidentiality, compliance with legislation and ensuring that prescribed benefits are not exceeded, top the list of major risks faced by South African medical schemes.

The Academy for Healthcare Management in the United States provides some indication of which risks are considered important for a healthcare organisation in the United States (Academy for Healthcare Management, 1999: 2-6 to 2-9):

- Strategic planning;
- legislative compliance (with specific reference to maintaining required statutory solvency levels);
- budgeting;
- incorrect premiums; and
- benefits exceeded

Regarding Europe, in chapter 5 section 5.3.2, legislative compliance and the development of a suitable regulatory framework are cited as the most pressing issues.

Although the United States and European risks are not prioritised, it is interesting to note that all of these risks appear within the top 15 risks reflected in the empirical study results included in figure 6.1.

#### **6.4 Summary and conclusion**

The chapter identifies the top risks faced by the medical scheme environment as confidentiality, compliance with legislation and ensuring that prescribed benefits are not exceeded. A complete prioritised list of the 45 risks faced by the environment is included in table 6.2 of this chapter. Similarities between the key risks within the American and European based healthcare organisations and South Africa was noted.

The medical scheme environment is a complex combination of processes and operations with the primary aim of ensuring that members are provided with cost effective health cover. To support this primary business objective it is necessary that risks are identified and suitably managed in a timely fashion.

The process followed in identifying the most significant risks within the medical scheme environment includes identification, analysis, measurement and prioritisation. The following chapters provide management with a suggested methodology that will initiate the journey and provide some suggestions on achieving world-class status regarding corporate risk management.

# Chapter 7

## Methodology Initiation

Lost Boy: "Injuns! Let's go get 'em!"

John Darling: "Hold on a minute. First we must have a strategy."

Lost Boy: "Uhh? What's a strategy?"

John Darling: "It's, er...it's a plan of attack

Walt Disney's Peter Pan

Someone unfamiliar with the mountains  
and forests cannot advance the army

Sun Tzu 500BC

## **7.1 Introduction**

After defining the key terms of risk and corporate risk management, it is necessary for the administrator to develop a suitable corporate risk management programme.

The development and implementation of a consistent risk management programme equips all functional unit owners within healthcare administration to identify the areas of opportunity, hazard or uncertainty. While senior management and the board attain great confidence that risk types are being optimally managed, unit owners are at the same time empowered to develop improved risk strategies and ultimately boost performance. This type of improved process management, however, requires a structured methodology that includes a number of distinct phases.

## **7.2 Aim**

The reader will be provided with a suggested methodology on how to implement corporate risk management within the healthcare administration organisation. The chapter will then identify suitable implementation criteria, which may be used to assess the organisation's readiness for such an endeavour, together with the steps that are included in setting the goals for the programme. Commentary on goal and objective setting will also be provided.

The chapter will conclude with a suggested oversight structure and results from the empirical survey will also be presented.

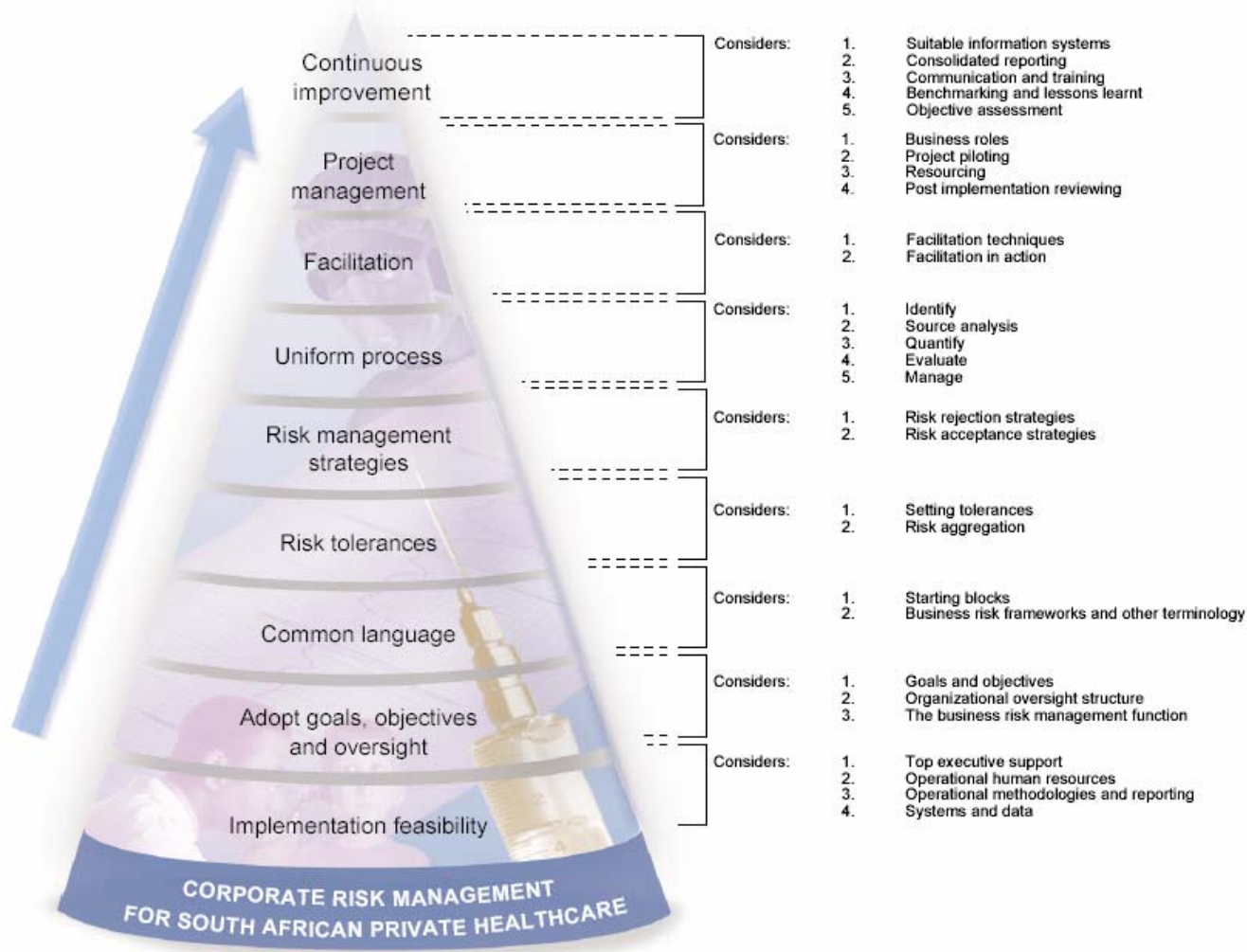
### 7.3 Corporate risk management methodology

Figure 7.1 introduces the suggested implementation methodology. In ensuring best practice, the author has consulted a selection of external sources:

- De Loach, 2000
- IFAC, 1999
- Kendall, 1998
- King Committee, 2002
- McNamee *et al.*, 1998
- PricewaterhouseCoopers, 2000a
- PricewaterhouseCoopers, 2000b
- Valsamakis *et al.*, 2000.

The remainder of chapter 7 will focus on implementation feasibility, adoption of goals and oversight structures.

Figure 7.1: Corporate risk management methodology





## 7.4 Implementation feasibility

Before the board of trustees and management embark on the implementation of or continue their journey towards corporate risk management, it is necessary that certain factors be considered. Although each of these criteria is important within their own right, the integration of each of these elements is vital for ensuring improved effectiveness and efficiency.

As corporate risk management is rolled-out to all affected business units, it is necessary that these criteria are assessed and suitable processes implemented to ensure their existence and ongoing effectiveness.

### 7.4.1 Top executive support

The key to the success of corporate risk management is that top executive commitment and priority is evident. A research study conducted in 2000 highlighted that if this unified support from the board was not in place, the corporate risk management initiative would in most cases fail (De Loach, 2000: 237).

This support is obtained is by the development of a compelling business case defining both the benefits and costs of converting to a fully integrated approach. The business case should consider the following minimum criteria:

- An assessment of the current risk management initiatives within the organisation referring especially to its anticipated positioning on the risk continuum. Refer table 4.1 of chapter 4.
- The opportunity cost should the board not embark on such a conversion process.
- An assessment of the organisation's ability to adapt to such a change in risk management methodology without detrimentally affecting its operations.
- Cost implications, both tangible and intangible, in initiating the project.

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- The ability of existing management information systems to meet or adapt to the demands of such an integrated approach.
- Reference to benchmarks of similar organisations within the industry or other appropriate professional comments from business consultants and change experts.

Buy-in from top management is obtained through a gradual process from awareness to fully integrated ownership. Top management should assume the role of identifying suitable champions within the respective business units and ensuring that the accepted risk management vision and associated policies are communicated and adhered to (De Loach, 2000: 238). Since corporate risk management forms part of the business's day-to-day operational agenda and is the responsibility of all managers, clearly articulated goals and objectives need to be established to ensure ongoing accountability.

#### *7.4.2 Operational human resources*

Since the implementation of a sound corporate risk management methodology may be jeopardised by a lack of human resources, it is necessary to ensure that buy-in from all levels of employees within the organisation is obtained. Organisations should adopt a top-down approach with regards to the assigning of responsibilities and a bottom-up approach in the implementation of information channels (Beaver *et al.*, 1995: 230-232).

Regular training on how risk management, internal control and process re-engineering can assist the organisation in achieving its corporate risk management vision should be ongoing.

#### *7.4.3 Operational methodologies and reporting*

The continued success of risk management and its progression towards a fully integrated approach requires management to adopt a culture of transparency.

Such a management culture requires regular feedback across all levels of management and lower tiers. Such feedback should be consistent and formalised. Formalised initiatives could include minute taking of significant meetings, management presentations or intranet sites detailing high level trends and other risk information.

#### *7.4.4 Systems and data*

Unmanaged organisational data is cited as one of the chief causes of failure when implementing an integrated risk management approach (McNamee *et al.*, 1998: 135).

Consistency in terms of risk types and control objectives are necessary for the success of corporate risk management. Such consistency is underpinned by systems and data that are accessible on a real time basis. Real time data availability would allow management to update their risk perceptions and the timely identification of areas requiring management attention. The most common types of problems encountered with current systems and data in the risk management environment include (SAS Institute, 2001):

- Untimely availability of information;
- inconsistent data quality;
- inability to compare data trends over time, across business units;
- inability to dissect data to identify root causes; and
- excessive manual intervention required to ensure data quality.

In many instances the initiation of a company-wide project to address reporting and data warehouse systems would assist in ensuring system and data reliability. Current corporate governance recommendations highlight the following standards on systems and data (King Committee, 2002: 101-102):

- Reliable data should be identified and communicated in a framework that would allow responsible personnel to discharge their risk management functions.

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- Escalation processes should be in place to ensure that both negative and positive data is communicated timeously.
- Structures, which promote best practice in terms of systems and data, are shared across the organisation to avoid data redundancy and duplication of effort.
- Suitable quality management initiatives are implemented to provide management with the necessary assurance that data and systems may be relied upon.

## **7.5 Adopt goals, objectives and oversight**

### *7.5.1 Goals and objectives*

- *Defined risk management vision:* Once the board of trustees are fully supportive of the business case and unanimously agree that corporate risk management will provide the organisation with the ability to increase shareholder value, top management must provide a compelling, shared vision. The shared vision will usually form the introduction to the risk management policy that would be approved by the board of trustees.

Since company-wide participation in the corporate risk management process is vital, a communications plan addressing a number of organisational concerns should be tabled and sufficient time provided for positive criticism and feedback (De Loach, 2000: 242). The communications plan could consider the following criteria:

- Expected benefits of introducing such an integrated approach;
- why a fragmented risk management initiative is no longer appropriate;
- how the change relates to the firm's objectives and strategies currently in place;
- that unanimous management commitment has been obtained;
- details on the accepted risk management vision and key policy guidelines;

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- the process according to which progress will be measured and feedback provided;
  - whether incentives will be introduced as part of the process;
  - brief description of the organisational structure that will be introduced to support the corporate risk management initiative; and
  - brief introduction of key role and responsibilities associated with the new structure.
- *Aligned risk management and business strategies:* For ensured success of the corporate risk management initiative, it is imperative that the risk management strategy be aligned with existing or future business strategies. Should such alignment not be ensured, confusion within the organisation is certain. It is recommended that the implementation of the corporate risk management strategy be performed in conjunction with a revision of all business strategies to ensure synergy. Questions that should be considered during this alignment exercise includes (De Loach, 2000: 94):
    - Is risk management a continuous or periodic activity?
    - How strong are the risk management capabilities when compared to competitors, particularly key operational activities?
    - Who is responsible for developing risk strategies and assigning risk authorities?
    - Who is responsible for executing those strategies and authorities?
  - *Risk management policy:* The administrator's risk management policy sets out its approach towards risk management and the organisation's attitude towards risk. Such a policy also defines designated responsibilities for risk oversight as well as reporting requirements. Annexure B includes a suggested policy.
    - *Best practice:* Such a policy should begin with the rudimentary requirements included in all applicable corporate governance and other legislative documentation, e.g. the revised King Report on corporate governance. Subsequent to this, suitable feedback sessions with key management personnel on their perceptions regarding risk management within the administrator should be initiated. Key

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responsibilities should refer to such initiatives. It is, however, generally accepted that the following issues are addressed in the policy (Pickford, 2000: 314):

- the objectives of risk management;
- definition of risk types;
- assignment of responsibility for risk management;
- risk management strategies; and
- risk reporting in terms of frequency and critical event monitoring.

To ensure quality, the board should consider requesting external governance specialists to provide input on additional best practice criteria and statements to be covered in the policy.

- *Obtain approval and communicate:* The corporate risk management policy should be adopted by management and endorsed by the board of trustees (IFAC, 1999: 27). The revised King Report recommends that the risk management policy should be clearly communicated to all employees to ensure that the risk strategy is incorporated into the language and culture of the company (King Committee, 2002: 99). This will require that management establish a strategy. This strategy should clarify basic risk management terminology, roles and responsibilities, awareness regarding the policy and associated procedures. (IFAC, 1999: 35). This would entail (AS/NZS 4360, 1999):
  - Establishing a team containing senior management personnel to be responsible for internal communications concerning the policy;
  - raising awareness regarding managing risks;
  - communication/dialogue throughout the healthcare organisation regarding managing risk and the associated policy;
  - obtaining input from experts so as to provide suitable skills to all responsible personnel through education and training;
  - ensuring appropriate levels of recognition, rewards and sanctions; and
  - establishing performance management processes.

### 7.5.2 Organisational oversight structure

Critical to the success of corporate risk management is the establishment of an effective oversight structure. The two subsections below provide comment on a suitable structure for the healthcare financing administrator and the expected roles and responsibilities within such a configuration.

Broadly speaking, an oversight structure ensures that the entire corporate risk management initiative effectively achieves the goals and objectives detailed in the risk management vision and associated policies. This process usually includes ensuring that risk owners are designated timeously and communication plans are both coherent and suitably executed. Figure 7.2 refers.

- Defined roles and responsibilities: Table 7.1 highlights the suggested responsibilities of the key role players within the organisational oversight structure specific to risk management. The table is subdivided into the specific requirements as set out in the revised King Report on Corporate Governance (King Committee, 2002) as well as international governance recommendations not included in the King Report. The following specific roles are elucidated upon in table 7.1:
  - Chief executive officer;
  - board of trustees;
  - risk management committee;
  - audit committee and internal audit;
  - chief risk officer;
  - chief operations officer; and
  - financial director.

The following sources were relied upon in identifying international governance recommendations not included in the King Report:

- De Loach, 2000
- IFAC, 1999

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- Kendall, 1998
- McNamee *et al.*, 1998
- PricewaterhouseCoopers, 2000a
- PricewaterhouseCoopers, 2000b.

It is generally accepted that the board of trustees are accountable to the stakeholders, understanding the critical risks, approving the corporate risk management policy and determining whether risks are in actual fact being managed and/or effectively exploited.

It is interesting to note the extent of additional best practice roles and responsibilities not included in the revised King Report. Senior healthcare administration personnel and the trustees of the medical scheme should be aware of these additional functions.

The chief executive officer is considered to be the comprehensive risk executive and is ultimately responsible for corporate risk management priorities, including facilitating the establishment of strategies and risk management tolerances. The most unique of the role players included in the oversight structure is that of the risk management committee. The committee coordinates the overall decision making regarding the entire corporate risk management programme. Annexure C includes a sample charter for a risk management committee.

As identified in figure 7.2, a division referred to as the risk management function will assist the chief risk officer in achieving his set responsibilities as detailed in table 7.1. The team comprises a group of dynamic risk specialists. The section below introduces the risk management function as well as the skill requirements of personnel involved in this activity.



### 7.5.3 The risk management function

The risk management function achieves its goals by providing enabling tools and frameworks to management. These tools, such as a common risk language facilitate the collection, analysis and synthesis of risk management data (De Loach, 2000: 97-100).

As can be understood from the beginnings of risk management referred to in chapter 4 section 4.3, the role of risk specialist had focused narrowly on insurance type tasks in the past. Non-industry specific roles and responsibilities of the traditional risk specialist included (Young *et al.*, 2001: 14):

- Buying and managing insurance coverage;
- implementing loss prevention and control programmes;
- reviewing contracts and documents for insurance purposes;
- providing training and education on safety related issues;
- arranging non-insurance financing schemes;
- designing and coordinating employee benefit programs;
- assuring compliance with government mandates, such as Occupational Safety and Health Acts; and
- Assisting in the review of mergers and acquisitions activities.

To meet the demands of corporate risk management, a new breed of specialist is needed. The two key traits, which a successful risk specialist requires, are to be a true generalist and be a strong advocate of teamwork and communication (Young *et al.*, 2001: 2). The following provides more detail on the associated traits, roles and responsibilities of this new specialist role (Pickford, 2001: 22-24 and De Loach, 2000: 97-100):

- Have a well developed “risk consciousness”;
- have a deep understanding of the workings of the organisation’s core business processes;

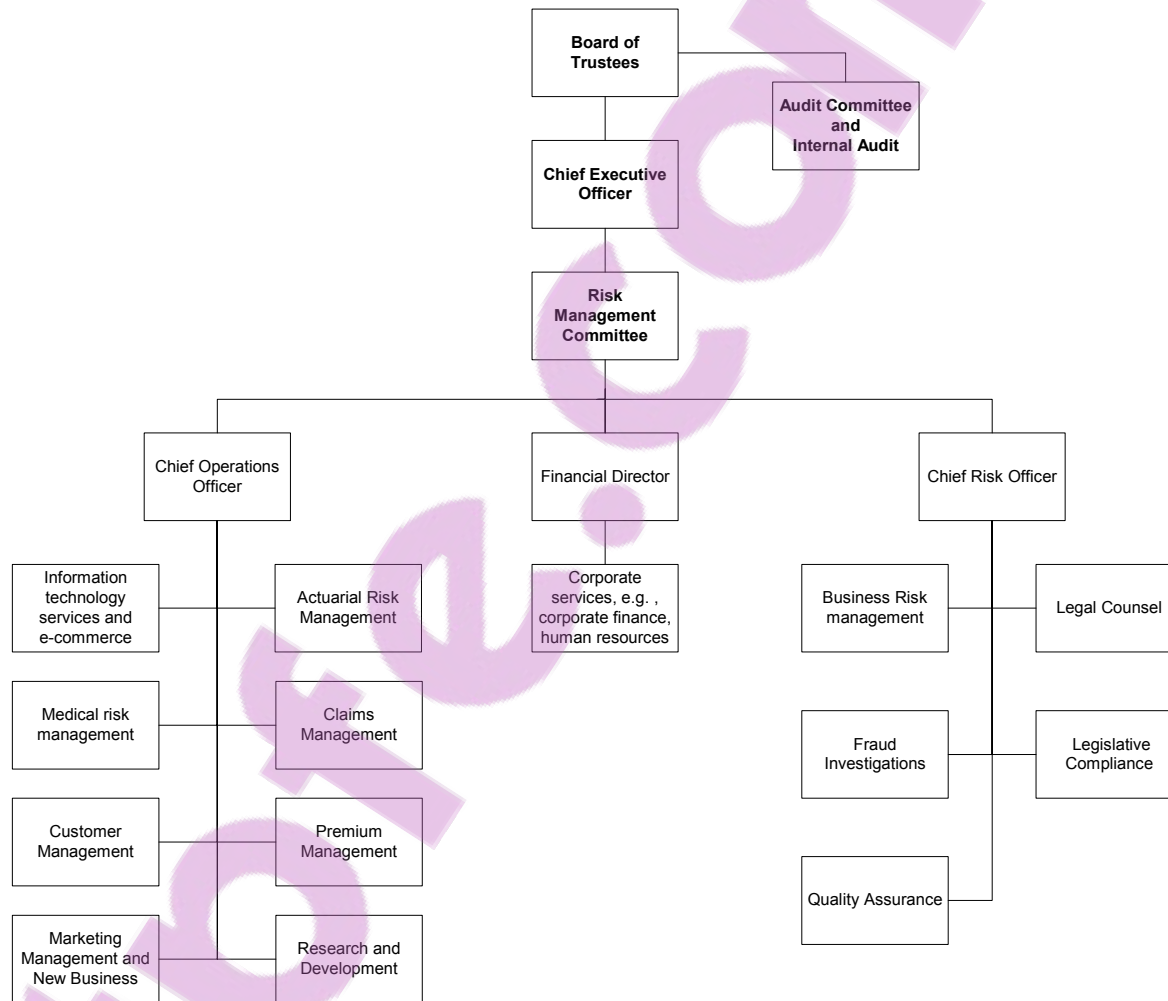
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- have completed a tertiary education and enrolled for suitable training programmes to stay abreast of changes within the field or risk management;
- have interpersonal skills, such as the ability to interact at varying levels of management and operations within the organisation;
- have expert skills in facilitation techniques. Refer chapter 9 section 9.4; and
- have an appreciation for finance, accounting and insurance. Caution not to over emphasise insurance as the core skills should be remembered.

The position of chief risk officer requires a person imbued with all of the above traits and above all, with the ability to act as the “glue” in coordinating all risk management activities. This coordination should avoid unnecessary duplication across the various assurance activities within the healthcare administration organisation. The appointment of such a person to the board is, as yet, not common (Young *et al.*, 2001: 14). Regular access to the board is, however, strongly recommended (Pickford, 2000: 23).

Figure 7.2: Suitable oversight structure (adapted from source: De Loach, 2000: 97-104)



**Table 7.1 – Roles and responsibilities**

<b>Role</b>	<b>King Report Recommendations</b>	<b>Additional Source References</b>
<b>Chief Executive Officer</b>	<ol style="list-style-type: none"> <li>1. Provide the necessary support and authority to ensure the effective implementation and ongoing success of the risk management process within the company.</li> </ol>	<ol style="list-style-type: none"> <li>1. Seen as the “comprehensive risk executive” and is ultimately responsible for corporate risk management priorities, including strategies, risk tolerance levels and policies. He/she acts as the final enforcer on all such matters.</li> </ol>
<b>Board</b>	<ol style="list-style-type: none"> <li>1. Assume full responsibility for the total process of risk management. This is accomplished by ensuring that the administrator has an effective, ongoing process in place to identify risk, measure its potential impact against a varied set of assumptions and perform what is necessary to proactively manage them.</li> <li>2. Ensure that appropriate risk tolerance levels are set and communicated to line management.</li> <li>3. Ensure that line management designs, implements and monitors the process of risk management and integrates it into the day-to-day activities of the administrator.</li> </ol>	<ol style="list-style-type: none"> <li>1. The board provides an oversight role and takes a holistic view of risk management by also perceiving risk as possible areas of opportunity.</li> <li>2. Develop a culture that rewards recognition, communication and management of risks.</li> <li>3. Human resource performance assessment, compensation and incentive programmes linked to managers’ risk management performance.</li> <li>4. Adoption of a common risk management language.</li> <li>5. Ensure that a suitable oversight structure is in place that includes senior management working committees, a senior executive for corporate risk management, formal charters and job descriptions, clear risk tolerance levels and effective reporting lines.</li> </ol>

Continued...

Role	King Report Recommendations	Additional Source References
	<p>4. Ensure that a company-wide risk assessment is conducted, at least annually, for the purposes of making its public statement on risk management.</p> <p>5. Report significant risks that could affect the decisions of stakeholders (including shareowners) in their dealings with the administrator and which should be disclosed in the annual report.</p> <p>6. Ensure that it is appraised of the most significant risks at appropriate intervals and determines, for each, whether the right actions are being undertaken. These assessments should also be utilised as a basis for determining whether the board believes that the business will be a going concern in the year ahead.</p> <p>7. In instances where the responsibility for administering the risk management process has been delegated to a board committee, review the appropriateness and effectiveness of the risk management committee. Ensure that a comprehensive system of internal control is maintained to ensure that risks are mitigated and that the administrator's objectives are attained.</p>	<p>6. Request corporate risk management and/or internal audit to assist in identifying, evaluating and assessing significant administration risks and the effectiveness of associated internal controls. The following criteria could be used to assess effectiveness:</p> <ul style="list-style-type: none"> <li>• Goals and values are established and communicated</li> <li>• The accomplishment of goals are monitored</li> <li>• Accountability is ensured</li> <li>• Corporate values are preserved.</li> </ul> <p>7. Adoption of a risk management framework, incorporating the following:</p> <ul style="list-style-type: none"> <li>• <i>Risk management policy</i> Defines the accepted approach to risk management and its attitude to, and appetite for, risk.</li> <li>• <i>Resourcing risk management</i> Details the identification of resources required to implement monitor and coordinate the risk management process including the reporting of risk management.</li> </ul>

Continued...

<b>Role</b>	<b>King Report Recommendations</b>	<b>Additional Source References</b>
	<ol style="list-style-type: none"> <li>8. Providing appropriate facilitation and support to line management regarding risk and internal control.</li> <li>9. Risks should be assessed on an ongoing basis and control activities designed to address individual risks.</li> <li>10. Pertinent information required to make educated risk management decisions is captured and communicated to appropriate personnel timeously.</li> <li>11. The adopted risk management process is sufficient to allow for a varying business environment and changes in key support structures.</li> <li>12. Set-up and maintain performance metrics to measure whether business units are taking the right risks to achieve the administrator's strategic objectives.</li> <li>13. Make suitable disclosures regarding the approved risk management process in the annual report and where the board cannot make any such disclosures, it should state this fact and provide a suitable explanation.</li> <li>14. Where joint ventures exist, refer to the alternative sources of risk management and internal control assurance in the annual report.</li> </ol>	<ul style="list-style-type: none"> <li>• <i>Implementation of risk management</i> The implementation of risk management involves the formalisation of the processes involved in the identification and definition of risk, the assessment of risk in terms of likelihood and consequence and the key aspects of associated internal controls.</li> <li>• <i>Risk management review and reporting</i> This formalises the process of risk review and reporting including both the form and regularity of reporting and the risk reporting structure.</li> </ul>

Continued...

<b>Role</b>	<b>King Report Recommendations</b>	<b>Additional Source References</b>
<b>Financial Director</b>	<ol style="list-style-type: none"> <li>1. Responsible for the risk management of areas, which traditionally fall within his/her area, e.g. treasury, credit control, etc.</li> <li>2. Acts on behalf of the chief executive officer in the implementation of the risk management process within other operational functions and areas.</li> </ol>	-
<b>Risk Management Committee</b>	<ol style="list-style-type: none"> <li>1. Ensure that the healthcare finance administrator has in place an effective, ongoing process to identify risk, measure its potential impact against a varied set of assumptions and do what is necessary to proactively manage them.</li> <li>2. Reporting of such issues (referred to in 1 above) to a separately established board committee and not the traditional audit committee. This is due to the fact that risk management constitutes an inherent operational function and responsibility.</li> </ol> <p>Conventional practice has found that a board committee comprising board trustees and senior management who are accountable to the board are much better placed to properly evaluate risk in the company and to report on it to the board.</p>	<ol style="list-style-type: none"> <li>1. The Risk management committee assumes the following additional responsibilities: <ul style="list-style-type: none"> <li>• Coordinates overall corporate risk management decision making, e.g. Approval of risk assessments relating to strategies and new service offerings to customers.</li> <li>• Evaluates the appropriateness of risk measurement methodologies and architectures and whether they are appropriate to the administrator's operations.</li> <li>• Ensures that sufficient capital is available for effective and efficient risk management implementation and execution.</li> <li>• Develops company-wide specific risk management policies that act as effective self-assessment guide.</li> <li>• Ensures that ongoing risk management training for senior executives is considered.</li> <li>• Assigns owners of significant risk types.</li> </ul> </li> </ol>

Continued...

<b>Role</b>	<b>King Report Recommendations</b>	<b>Additional Source References</b>
	<ol style="list-style-type: none"> <li>3. Should be free to obtain independent, outside professional advice as and when necessary.</li> <li>4. The risk management committee should be subject to regular evaluation on their performance and effectiveness.</li> <li>5. The committee should disclose its composition; provide a brief description of its remit and the number of meetings held. Furthermore, the chair of the committee should be in attendance at the healthcare finance administrator's annual general meeting.</li> </ol>	<ol style="list-style-type: none"> <li>2. The risk management committee should at all times display the attributes of independence and authority in equal proportions.</li> <li>3. Meetings should be scheduled in advance, at times which would ensure that all relevant personnel may provide meaningful input.</li> <li>4. The risk management committee should have unrestricted access to the board of trustees.</li> <li>5. The risk management committee should not be involved in the day-to-day running of the administrator except insofar as the management of risk is concerned. Accordingly, it is essential that it does not usurp the role of the board of trustees and line management.</li> <li>6. Regarding the chairman of the risk management committee: <ul style="list-style-type: none"> <li>• The chairman should be independent of the activities that the risk management committee oversees.</li> <li>• The chairman's remuneration should not be linked directly to the performance of his or her duties.</li> </ul> </li> <li>7. Regarding the members of the risk management committee: <ul style="list-style-type: none"> <li>• The number of members should be limited so that the committee remains flexible enough to effect timely decisions, e.g. five members.</li> <li>• Membership of the committee should be based on the type and size of the healthcare administrator.</li> <li>• Members with strong legal, corporate finance backgrounds are recommended.</li> </ul> </li> </ol>

Continued...



Role	King Report Recommendations	Additional Source References
		<ul style="list-style-type: none"> <li>• Membership of the chief risk officer is ensured.</li> <li>• The company's legislative compliance officer should either be a member or secretary of the committee.</li> </ul>
<b>Chief Operations Officer</b>	<ol style="list-style-type: none"> <li>1. Accountable to the board for designing, implementing and monitoring the process of risk management and integrating with daily operational activities.</li> <li>2. Developing generally accepted risk management frameworks that are also integrated into daily operational activities.</li> <li>3. Provide the necessary assurance to the board that the designing, implementing and monitoring of the risk management process has been conducted in an appropriate and effective manner.</li> </ol>	<ol style="list-style-type: none"> <li>1. Business management assumes the following additional responsibilities: <ul style="list-style-type: none"> <li>• Manage significant risk types and report results according to established reporting protocols.</li> <li>• Formulate risk management strategies consistent with the administrator's wide approach.</li> <li>• Target new project and development initiatives to create new sources of value consistent with enterprise-wide policies.</li> <li>• Assign risk management responsibilities within their respective business units and create a risk awareness culture.</li> <li>• Report on the overall quality of the corporate risk management process to senior management.</li> </ul> </li> </ol>
<b>Chief Risk Officer</b>	<ol style="list-style-type: none"> <li>1. Acts as business management's coach by assisting them in designing and implementing suitable risk management architecture and regularly reviewing such systems for appropriateness and effectiveness.</li> <li>2. Monitor the company-wide risk profile and ensure that major risks are identified and reported upwards.</li> </ol>	<ol style="list-style-type: none"> <li>1. Is a member of the risk management committee and reports either to the chief executive officer or another member of the board of trustees.</li> <li>2. Oversees the corporate risk management function and is the ultimate champion of the corporate risk management framework process.</li> </ol>

Continued...

<i>Role</i>	<i>King Report Recommendations</i>	<i>Additional Source References</i>
	<ol style="list-style-type: none"> <li>3. Assist the board in fulfilling their corporate governance responsibilities.</li> <li>4. Assist in the execution of the approved risk management process.</li> </ol>	<ol style="list-style-type: none"> <li>3. Not responsible for risk management, but facilitate, challenge and drive the integrated approach.</li> <li>4. May have authority for managing a selection of significant risk types.</li> </ol>
<b>Audit Committee And Internal Audit</b>	<ol style="list-style-type: none"> <li>1. Internal audit does not assume the functions, systems and process of risk management but assists the board and management in the monitoring of the risk management process.</li> <li>2. Assist the board of trustees and management in identifying, evaluating and assessing significant organisational risks but not assume the functions, systems and processes of risk management.</li> <li>3. Monitor the progress of business units in managing their risks in coordination with the corporate risk management function.</li> </ol>	<ol style="list-style-type: none"> <li>1. Leverage knowledge of the line's risk management architecture in targeting prospective areas for internal audits.</li> <li>2. Change in the internal auditor's paradigm from old to new, in terms of (next page):</li> </ol>

Continued...

Role	King Report Recommendations	Additional Source References		
	<p>4. An effective internal audit function should provide:</p> <ul style="list-style-type: none"> <li>• Assurance that the risk management process is adequate to identify and monitor significant risks.</li> <li>• Credible processes for feedback on risk management and other assurance services are in place.</li> </ul> <p>5. Internal audit also monitors, through its own assurance processes, the progress of business units in managing their risk in coordination with the chief risk officer or risk committee.</p>	<b>Area</b>	<b>Old</b>	<b>New</b>
		<b>Internal audit focus</b>	Internal Control	Risk
		<b>Internal audit response</b>	Reactive	Real time
		<b>Risk assessment</b>	Risk factor based	Scenario planning
		<b>Audit testing</b>	Key controls	Key risks
		<b>Audit methods</b>	Emphasis on completeness of control testing	Emphasis on significant risks
		<b>Recommendations</b>	Internal control: <ul style="list-style-type: none"> <li>• Strengthened</li> <li>• Cost-benefit</li> <li>• Effectiveness</li> </ul>	Risk management: <ul style="list-style-type: none"> <li>• Avoid/diversify risk</li> <li>• Share/transfer risk</li> <li>• Control/accept risk</li> </ul>
		<b>Audit reports</b>	Internal control focused	Process risk focused
		<b>Role in organisation</b>	Independent appraisal	Element of corporate risk management process

## 7.6 Corporate risk management in South Africa

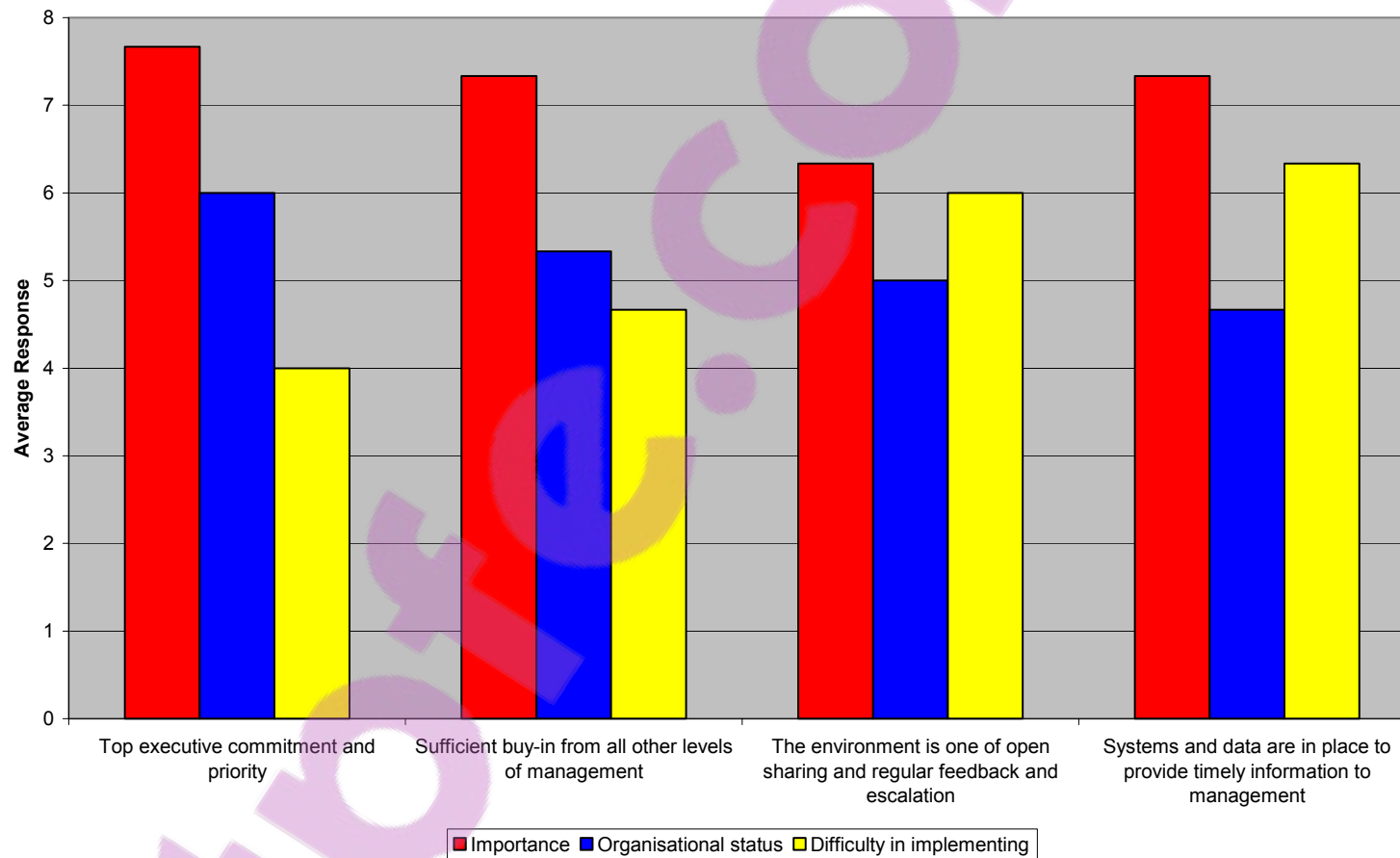
Results of the local survey are featured below. These results relate specifically to the implementation feasibility and suitable goals, objectives and oversight structures within the corporate risk management initiative:

Scales applied in the empirical study were as follows:

<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
<i>Organisational Status</i>	>8 = Managed/optimised.....7.....6 = defined.....5.....4..... 3 = repeatable.....2.....1 = initial/rudimentary
<i>Difficulty in Implementing</i>	>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

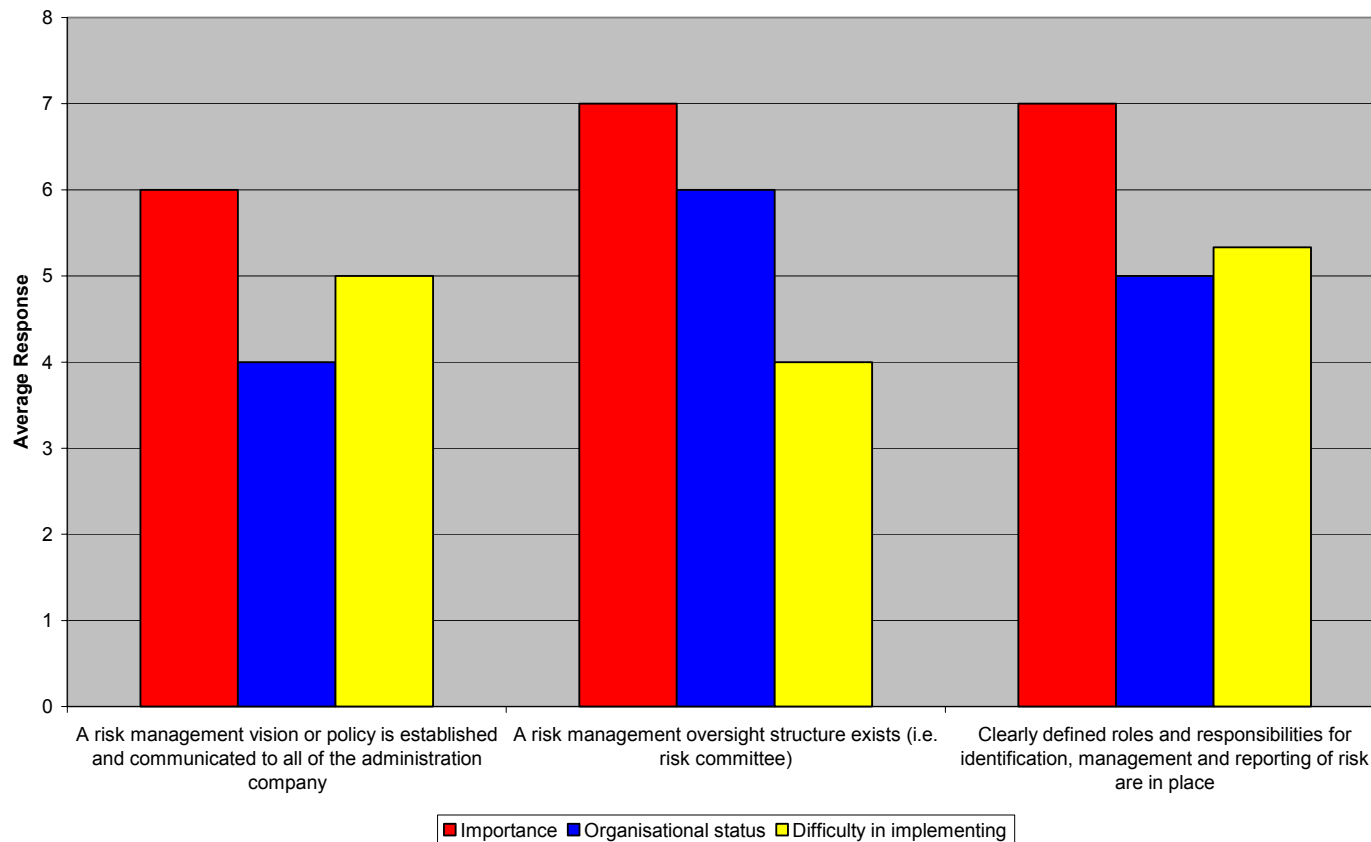
**Figure 7.3: Empirical study results: methodology initiation phase**

Criteria below detail the action steps followed within the methodology initiation phase of a corporate risk management programme



**Figure 7.4: Empirical study results: adoption of goals, objectives and oversight phase**

*Criteria below detail the action steps followed within the adopt goals, objectives and oversight phase of a corporate risk management programme*



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

- Top executive commitment and buy-in was considered the most important element of the methodology initiation phase. The need for up to date systems and data to provide timely information was considered to be the most difficult step in implementing whilst top executive commitment was considered the most simple.
- A suitable oversight structure and the need for clearly defined roles and responsibilities was considered very important to the respondents within the adopt goals, objectives and oversight phase. The most difficult step in implementing within this phase was clearly defined roles and responsibilities.

### **7.7 Summary**

This chapter details a suggested corporate risk management methodology for the private healthcare administrator. The chapter provides details on the implementation feasibility, goals, objectives and oversight phases.

Within the phase of implementation feasibility, the following issues were elucidated upon:

- Top executive support;
- operational human resources;
- operational methodologies and reporting; and
- systems and data.

In terms of the adoption of goals, objectives and oversight structures, key issues raised were:

- Goals and objectives, in terms of a defined risk management vision, alignment of risk management and business strategies and a risk management policy;
- organisational oversight structure, in terms of defined roles and responsibilities; and

- the risk management function.

A suitable organisational oversight structure for the healthcare administrator is introduced and corporate governance responsibilities for key role players in relation to risk management are summarised.

The results of the empirical study confirm that top executive commitment and buy-in as well as the need for a suitable oversight structure are of paramount importance.

### **7.8 Conclusion**

The implementation of corporate risk management requires a methodology to be developed, which considers and builds on the strengths of existing risk management initiatives, within the healthcare administration organisation.

The success of a corporate risk programme requires the dedication of all levels of management. To obtain this buy-in, it is necessary that the programme not be tenuous but sufficiently defined and structured to suitably address the diverse types of risks faced. Key elements of the programme can be incorporated into a risk management policy, which addresses the objectives of risk management, roles and responsibilities and risk management strategies. Risk management strategies will be one of the key themes of the next chapter.



# Chapter 8

## Common Language and Strategies

The Lord said “If as one people  
speaking the same language  
they have begun to do this, then  
nothing they plan to do  
will be impossible for them”

The Holy Bible, Genesis 11:6

If language is not correct,  
then what is said is not what is meant,  
if what is said is not what is meant,  
then what must be done remains undone

Confucius 551 - 479BC

## 8.1 Introduction

Chapter 7 addressed two of the six phases within the corporate risk management methodology. Chapter 8 will continue by providing insight on the phases relating to the adoption of a common risk management language, setting of tolerances and the establishment of suitable risk management strategies.

The absence of a consistent language leads to miscommunication and oversights. Within a corporate risk management programme a common language affords the following significant benefits to the administrator:

- Provides employees and other affected stakeholders with the ability to not only perceive risk as negative but also as possible areas of opportunity not previously considered.
- Allows the organisation to aggregate risk exposures across multiple processes and business functions.
- Provides the board with the assurance that the shared risk management vision can be attained as all stakeholders perceive key risk management terms in the same light.
- Allows for the effective identification and assessment of exposures while ensuring that potential sources of uncertainty are capitalised upon (De Loach, 2000: 59).

In 1963, one of the earliest contributions to the field of risk management was made. The authors, Mehr and Hedges, in their book titled *Risk Management in the Business Enterprise* defined the following as the three primary rules of risk management (Mehr *et al.*, 1963: 16-26):

- Do not risk more than can be lost;
- consider the odds; and
- do not risk a lot for a little.

These are timeless principles that are applicable to the setting of tolerances and the adoption of the most appropriate risk management

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strategies. Risk management tolerances involve the establishment and communication of the risk appetite of the administrator while risk management strategies exist to assist the board and management in suitably optimising their approach towards the unique risks faced.

**8.2 Aim**

The chapter aims at providing the reader with an understanding of common language and how risk management tolerances are determined and applied. It concludes with details on accepted risk management strategies that may be used in the private healthcare administration company.

Suitable empirical study results will also be presented.

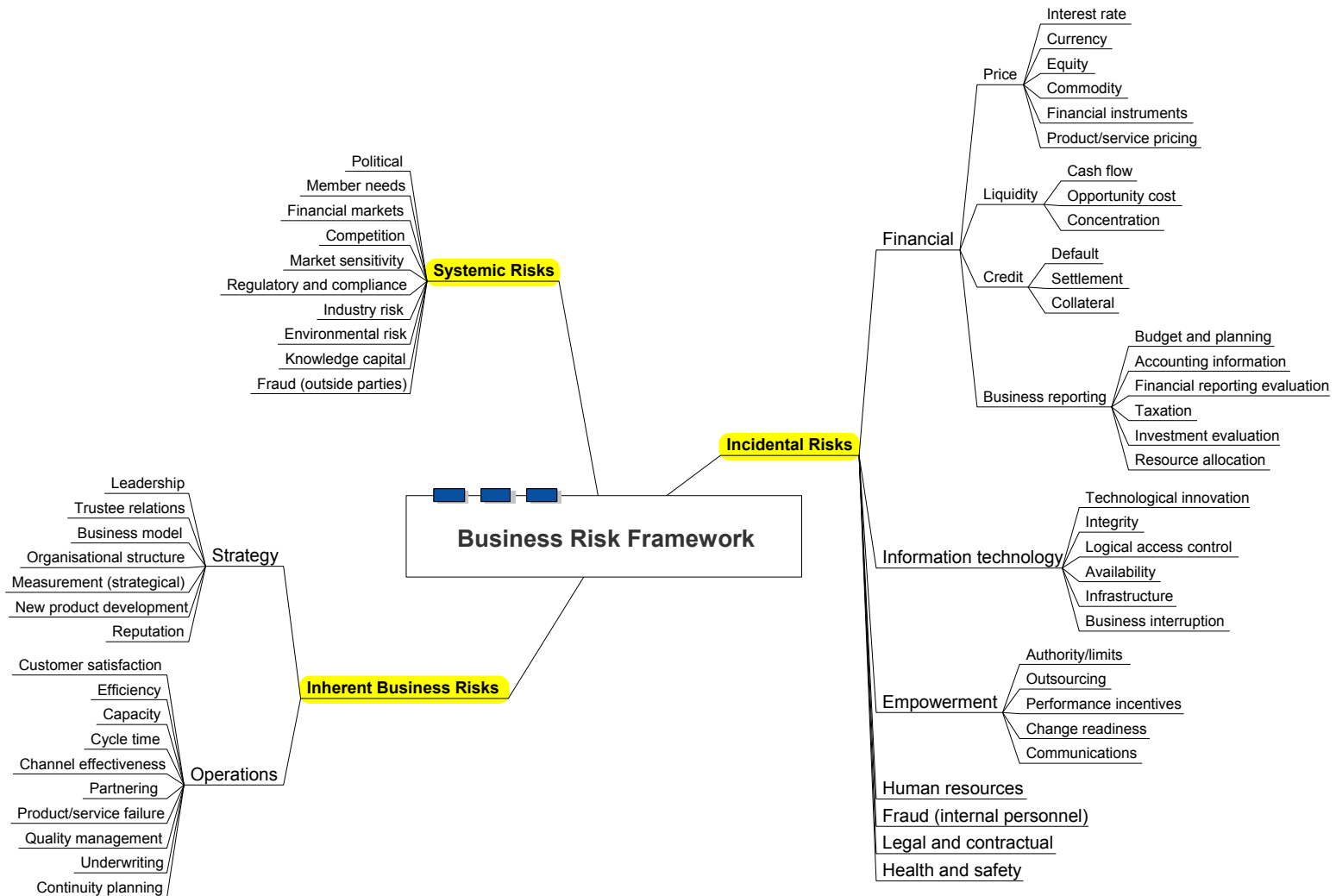
**8.3 Common language***8.3.1 Starting blocks*

Earlier the definitions for risk and corporate risk management were set out. These definitions are the starting blocks of a common body of terminology that should be communicated and entrenched into the daily risk management operations of the administration organisation.

*8.3.2 Risk frameworks and other terminology*

Risk frameworks are a key component of any corporate risk management programme. They provide personnel with a tool to assist in identifying sources of uncertainty. It is imperative that the risk framework be general in nature so that all sources and classifications of risk are included (De Loach, 2000: 52). Figure 8.1 details a suggested risk framework that may be applied by management within the healthcare environment thereby ensuring that key risk types are identified and suitably assessed.

Figure 8.1: Suggested risk framework



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The framework is subdivided into risk categories detailed in table 6.2 of chapter 6 and for completeness, verified against the following source reference: De Loach, 2000.

With regard to other consistent terminology, other definitions and terms will be applied which require similar communication and entrenchment as that of risk. These other terms should form part of the common language dictionary applied throughout the administration organisation. Other terms could include absolute risk levels, controls, residual risk scoring, etc.

Numerous methods and techniques may be applied to increase employee awareness:

- Intranet sites with dedicated risk management sections;
- Regular internal newsletters; and
- Frequent presentations at key management boards and executive committees.

## **8.4 Risk tolerances**

### *8.4.1 Setting tolerances*

Our suggested corporate risk management methodology requires that approved tolerances be set for each of the major risk types faced by the medical scheme.

The maximum risk exposure will vary depending on the nature of the risk at hand. We can summarise the types of exposure into the following three categories (adapted from Young *et al.*, 2001: 175-269):

- *Physical asset exposure*: This category is further subdivided into four elements, viz.:
  - *Fixed and movable property*: This includes land, fixed structures on such land, etc. It is generally accepted that such fixed assets exposure to risk is more constant and knowable than assets whose

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physical location changes. Such portability introduces a new dimension to the nature and character of risk. This element of physical asset exposure does hold a strong insurance influence. Historically, insurers were uncomfortable with assets that moved since it was difficult to ascertain the likelihood of harm. Due to this degree of uncertainty it is believed that the field of insurance developed into two distinct parallels, viz. one dealing with movable property, also known as marine insurance and fixed property insurance such as fire insurance. Although the purchaser of fixed and movable property insurance may not be aware of the differentiation, the problematic distinctions are still manifest in policy language, exclusions, pricing and claims management procedures.

- *Gain*: This element considers natural hazard-based or behavioural hazard-based perils. Perils arising from natural hazards are the most simple to understand and include acts of God such as earthquakes, freezing weather conditions, etc. Behavioural hazard-based perils include human acts such as vandalism, riots, and a broad range of social, political and economic phenomenon that arise from collective behavioural influences.
- *Loss*: Loss is defined according to direct impacts and consequential impacts. In the case of direct impacts, this refers to the loss incurred from the actual accident or exposure, e.g. loss of member data due to a system failure or computer virus. Consequential impacts refers to the indirect effects of the actual accident or exposures, e.g. loss of funds, medical scheme's reputation, etc.
- *Interest*: A factor that will significantly affect the medical scheme's physical asset risk exposure and the setting of tolerances will depend on whether the asset is owned, rented or being leased from a third party.
- *Financial asset exposure*: Financial assets possess a feature distinguishing them from physical assets, viz. their value is resultant from another asset (which in many cases is not held by the owner of the financial asset). The most common types of financial assets include an array of different derivative contracts such as options, forwards,

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futures, etc. Exposure to financial assets arises either from holding or issuing them and is described as either being price, credit, interest, rate or currency exchange based.

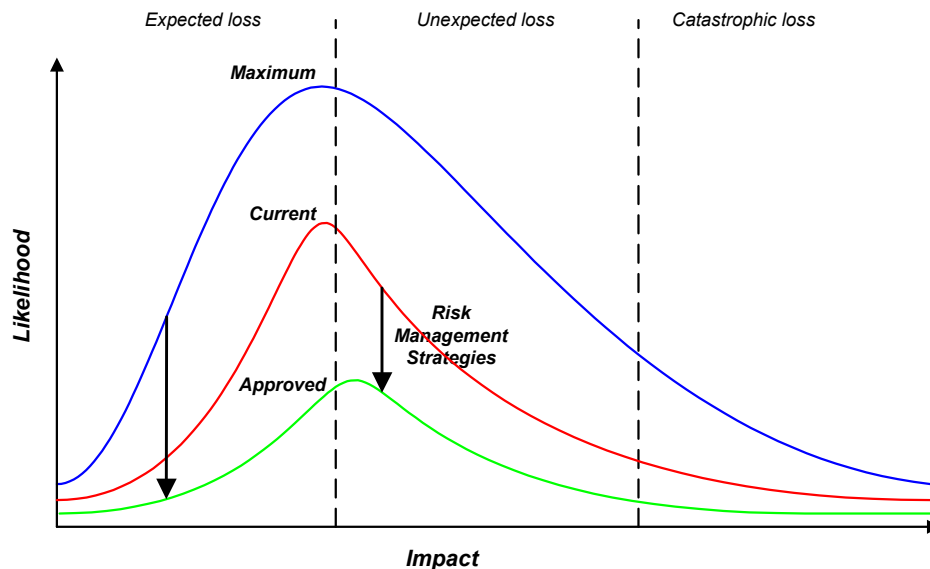
Even though these types of exposure have existed for hundreds of years, the management of such financial asset exposures has been difficult due to a lack of financial tools. This has, however, improved due to advancements in the area of derivative contracts as well as greater access to the tools of financial risk management and the formation of markets for pooling and distributing financial risks.

- *Human asset exposure*: Knowledge management and the retention of innovative ideas and thoughts is fast becoming one of the most important assets facing exposure within healthcare administration organisations. As one of the key components of the suggested business risk framework referred to in figure 8.1, human asset exposure may be categorised by elements such as poor productivity, fraudulent activity and lack of shared vision. Although extremely difficult to measure it is vital that these potential hazards are identified and that tolerances are implemented, which will allow for the timely identification of out-of-bound practices.

Figure 8.2 below depicts the two various tolerance levels faced by the scheme during the corporate risk management process, viz. maximum and approved.

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**Figure 8.2: Risk tendencies** (adapted from source: Arthur Andersen, 2001)



In setting tolerances, the trustees of the medical scheme will be most concerned with defining the maximum risk level or capacity to bear risk. This capacity is often difficult to determine since it is a function of many factors such as human resources, information technology, legislative compliance and earnings sensitivity (De Loach, 2000: 213). Certain writers prefer to envisage such maximum tolerances as markers that trigger senior management discussion since the process of determining them is so complex (Pickford, 2000: 304).

Maximum tolerances used in company-wide assessments will represent “no go” areas for the administrator. Management, with the assistance of the risk management committee, should ensure that all assessments conducted clearly identify when such “no go” areas are being breached. It is vital that operational management and employees are made fully aware of these maximum tolerances so that proactive steps and meaningful measures may be implemented to ensure that they are not exceeded.

In terms of escalated reporting, any breach of such tolerances should be communicated to the trustees and appropriate risk management strategies



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implemented to negate further non-compliance. Risk management strategies are discussed in section 5 below.

This process of setting maximum tolerances should be determined whenever any new initiatives or projects are being considered. Since new projects introduce a plethora of new risk types, the administrator should seek to define these before new initiatives become operational. Again, the communication of updated or new risk tolerances should take place (Chong: 2000).

Approved risk tolerances indicate where return on investment is maximised and no further risk management strategies are required to address unacceptable levels of risk. In such instances where these tolerances are attained, management should seek to maintain them. In many cases the administrator may choose to link satisfactory risk management performance to employees' remuneration (Harvard Business Review, 2002a: 16-17).

In most instances, non-compliance will represent areas between the maximum and approved tolerances such as that depicted by the current level in figure 8.2. Such instances will require the implementation of a suitable risk management strategy and will be actioned as part of the uniform risk management process detailed in Chapter 9.

The setting of tolerances should not hinder operational flexibility but provide management with the ability to innovate and maximise return within acceptable boundaries (De Loach, 2000: 203).

#### *8.4.2 Risk aggregation*

Risk aggregation or neutralisation (Young *et al.*, 2001: 147), is a key trait that differentiates corporate risk management from previous approaches. With this approach, the medical scheme will look at managing the total

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pool of risk rather than the individual risk categories. This approach provides the following benefits (De Loach, 2000: 200-201):

- Risk owners have the ability to understand whether risks are increasing or decreasing as conditions change in the aggregate versus the scheme's established risk tolerances.
- Provides senior management and trustees with the necessary assurance that decisions are being made based on a holistic view of the medical scheme's activities.
- Improved and simplified management reporting thereby allowing the effective allocation of limited organisational resources.

The process of risk aggregation is complex and requires that each risk be assessed, quantified and linked to other common risk types. Choosing the most appropriate level of aggregation will depend on the organisational level at which final risk management reporting is aimed (ibid), i.e. senior management requires more strategic reporting while operational reporting for lower level personnel will focus on detail.

Risk aggregation can allow for individual risks within the same risk pool to be completely or partially offset against each other (Pickford, 2000: 70). This aggregation allows the trustees and management to then implement strategies that focus on the net exposure of the risk. This will then in turn allow management to seek the most effective risk management strategy thereby ensuring costs are reduced and the effectiveness of operations maximised. Such aggregation has proved successful in many industries (Pickford, 2000: 71):

*"In 1997, the technology products group, Honeywell, purchased an insurance contract. This contract, the first of its kind, combined protection against traditionally insurable risks such as property casualty and foreign exchange risk, a financial market risk more typically managed through derivative securities.*

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*The important innovation of the contract was that it covered Honeywell's aggregate losses, meaning that the policy had an aggregate deductible rather than a separate deductible for each risk. By aggregating individual risks and then insuring the total, Honeywell was able to purchase a contract that cost 15% less than its previous contract, since the new policy cost less for underwriter's, American International Group (AIG), to produce."*

### **8.5 Risk management strategies**

Once the acceptable risk management tolerances have been set for the specific risk types within the medical scheme environment, it is necessary that suitable risk management strategies be defined to reduce current levels of risk that exceed approved tolerances. Figure 8.2 also depicts the effect that approved risk management strategies can have in reducing maximum and current levels of risk. Management will need to determine whether the individual or pooled risks currently being assessed should be accepted or rejected. An acceptable risk will include those that management believes are necessary to ensure that the strategies and mandate set by the trustees of the scheme are achieved. On the other hand, risks that are considered undesirable represent types that fall outside of the medical scheme's mandate and which should be avoided.

Once the acceptability of each risk or pool of risk is determined, it is then necessary that suitable risk management strategies are applied. This application process will require management to consider the size of the potential loss, its probability and the resources available should the loss materialise. Based then on the best information available and under direction of the risk management policy, a suitable risk management strategy should be adopted (Vaughn *et al.*, 1996: 39).

To ensure that administration costs are minimised, it is necessary that only the technique that represents the lowest cost approach to the individual or pooled risks is applied by management. Also, a given strategy should be

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used only until the last Rand spent achieves a Rand reduction in the cost of risk (Vaughn *et al.*, 1996: 42).

Table 8.1 introduces common forms of risk management strategies, which are applicable in the healthcare administration environment. The following sources have been relied upon in preparing this summary:

- IFAC, 1999: 39
- De Loach, 2000: 130
- Vaughn *et al.*, 1996

Table 8.1 – Risk management strategies

<i>Focus</i>	<i>Strategy</i>	<i>Technique</i>	<i>Description</i>
<b>Risk Rejection</b>	<b>1. Avoid</b>	Divest	By exiting a market or eliminating a product group or business function.
		Prohibit	Unacceptably high-risk activities, transactions, financial losses and asset exposures through appropriate limit structures and corporate standards.
		Stop	Specific activities by redefining objectives, refocusing strategies or redirecting resources.
		Target	Business development and market expansion to avoid pursuit of 'off-strategy' opportunities.
		Screen	Alternative capital projects and investments to ensure member funds are protected.
		Eliminate	At the source by designing and implementing internal preventive processes.
<b>Risk Acceptance</b>	<b>1. Retain</b>	Accept	Risk at its present level taking no further action.
		Reprice	Products/services by including an explicit premium in the pricing, market conditions permitting, to compensate for risk undertaken.
		Self-insure	Risk through: <ul style="list-style-type: none"> <li>• Provisions to the income statement and balance sheet</li> <li>• Trappings of insurance conditions</li> <li>• Borrowed funds (from external sources should a risk event occur)</li> <li>• Reserving losses (under accepted accounting principles)</li> <li>• Participation in a group or an industry captive</li> </ul>
		Offset	Risk against others within a well defined pool.
		Plan	For well defined contingencies by documenting a responsive plan and empowering people to make decisions and periodically test and, if necessary, execute the plan.
		<b>2. Reduce</b>	Disperse
	Control		Risk through internal processes or actions that reduce the likelihood of undesirable events occurring to an acceptable level (as defined by management's risk threshold).

Continued...

<b>Focus</b>	<b>Strategy</b>	<b>Technique</b>	<b>Description</b>
<b>Risk Acceptance</b>	<b>3. Transfer</b>	Insure traditionally	Through cost-effective contract with independent, financially capable, party under a well defined risk strategy.
		Reinsure	To reduce portfolio exposure through contracts with other insurers, when such arrangements are available.
		Hedge	Risk by entering into the capital markets, making feasible changes in operations or executing new borrowings.
		Diversify	Financial, physical, customer, employee/supplier and organisational asset holdings used by firm's business model.
		Expand	Business portfolio by investing in new industries, geographic areas and/or customer groups.
		Create	New value adding products, services and channels.
		Redesign	The firm's business model, i.e. its unique combination of assets and technologies for creating value.
		Reorganise	Processes through restructuring, vertical integration, outsourcing, re-engineering and relocation.
		Price	To influence customer choice toward products that suits the firm's risk profile.
		Renegotiate	Existing contractual agreements to reshape risk profile, i.e. transfer, reduce or take risk differently.
Influence	Regulators, public opinion and standards setters through focused lobbying, political activism, public relations, etc.		

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The subsections below will describe the most unique types of risk management strategies encountered. The remaining techniques are self-explanatory and sufficient descriptions are included in table 8.1.

### 8.5.1 Risk rejection strategies

- *Avoid*: Risk is avoided when the medical scheme's management or trustees refuse to accept a risk even temporarily. The prerequisite of risk avoidance is recognising the hazards in an activity so the activity can be prevented (Vaughn *et al.*, 1996:38).

Choosing not to expose an organisation does not consume many resources. However, avoidance is not always costless since avoiding a risk could prevent the organisation from realising certain unforeseen opportunities attached to the risk (Young *et al.*, 2001: 130).

### 8.5.2 Risk acceptance strategies

- *Retain*: In instances where the administrator does not take positive action to avoid, reduce or transfer a risk, it is then retained. This retention strategy may be conscious or unconscious (Vaughn *et al.*, 1996: 38), and may expose the administrator to greater risk (Harrington *et al.*, 1999: 273).

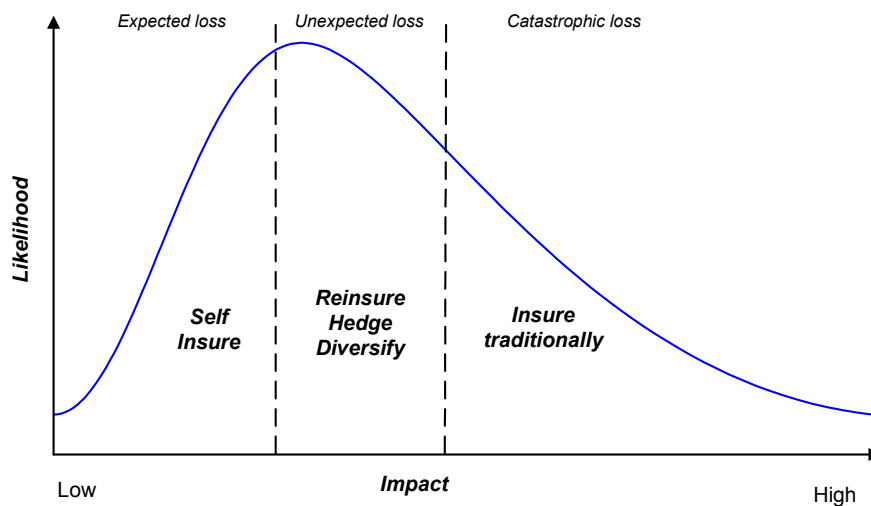
The administrator will in most cases choose this strategy only where losses are reasonably predictable, with a small likelihood of deviation from year to year. A basic guideline for optimal retention decisions is to retain reasonably predictable losses and insure potentially large, disruptive losses (Harrington *et al.*, 1999: 275).

Within the retention strategy, self-insurance is the most unique. Figure 8.3 below depicts when the utilisation of self-insurance is the most appropriate in comparison to other outsourced arrangements. Self-insurance is distinguished from other retention techniques in

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the formality of the arrangement. In some instances the approach varies from obtaining authorisation from regulatory agencies to ensuring that calculations are supported by valid actuarial calculations. Such instances could include provisions relating to claims incurred but not reported; often termed outstanding claims provisions in the medical scheme environment.

**Figure 8.3: Risk financing strategies**<sup>1</sup>



The major advantage of utilising self-insurance is that it avoids costs that are usually associated with traditional insurance. These include broker commissions, overhead expenses and profit margins. In addition to this, the administrator may be of the opinion that its loss experience is far better than the average on which premiums are based (Vaughn *et al.*, 1996: 50). In terms of disadvantages regarding self-insurance, the following are noteworthy (*ibid*):

- Self-insurance can expose the administrator to catastrophic loss. In such instances the organisation would not have sufficient provisions to cover such severe cases. This

<sup>1</sup> Adapted from sources:

- Pickford, 2000: 200
- Alexander, 2001: 216



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disadvantage could, however, be reduced or even eliminated by utilising a combination of self-insurance and one of the transfer strategies such as traditional insurance.

- Traditional insurance providers allow for a number of ancillary services to customers that may be of significant benefit. These include claims handling, overall administration services, etc. In cases where the business opts for self-insurance these services would be unavailable.
- *Reduce*: It is accepted that effective actions aimed at minimising risk could be more cost effective than utilising a transfer strategy such as traditional insurance cover (Vaughn *et al.*, 1996: 38).

Of the two techniques included under the reduction strategy, control measures are the most widely applied. Controls include all activities conducted for the purpose of (Valsamakis *et al.*, 2000: 106-107):

- Eliminating or reducing the factors that may cause loss to the medical scheme; and
- minimising the actual loss that occurs when other preventative methods have not been fully effective.

Control processes reduce the likelihood of the exposure and include pervasive and reactive measures (De Loach, 2000: 131-132). Internal Control is defined as (Sawyer *et al.*, 1996: 102-108):

*“The employment of all means devised in an enterprise to promote, direct, restrain, govern and check upon its various activities for the purpose of seeing that enterprise objectives are met.”*

Control is achieved by means of (Gleim, 2001: 120-123):

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- *Organisation*: This is an intentional structuring of roles assigned to people within the company to achieve its objectives efficiently and economically.
- *Policies and procedures*: Policies are stated principles that require, guide or restrict action, whilst procedures are methods employed to carry out activities in conformity with such prescribed policies.
- *Personnel*: Personnel employed should have sufficient qualifications to complete required assignments. In addition to this, the best control over performance is the supervision of staff.
- *Accounting*: Accounting is the requisite means of financial control over activities and resources. It provides a structure that may be applied to assignments of responsibility.
- *Budgeting*: Budgeting sets a standard for input of resources and what should be achieved as output and income.
- *Reporting*: Reports are relied upon within organisations to make decisions. Reports should be timely, accurate, meaningful and economical.

It is important to note at this point that in certain instances the risk management strategy of control may be mandated by law (Young *et al.*, 2001: 149). The appointment and integration of a compliance officer who oversees observance to regulations and statutes should be considered by the trustees and senior management.

- *Transfer*: The most formal transfer technique and by far the most common, is the purchase of third party insurance (Vaughn *et al.*, 1996: 39). Figure 8.3 identifies traditional insurance as being applied when cover is required for catastrophic losses that have a low likelihood of occurrence. The ideal elements of an insurable risk will usually include the requirements that the risk results in an

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accidental loss, that the loss is measurable and predictable (Vaughn *et al.*, 1996: 28).

Insurance is a complicated risk management technique and characterised by the following two fundamental components (Vaughn *et al.*, 1996: 19):

- Involves the transferring or shifting of risk from an individual organisation to a group; and
- involves the sharing of losses on some predetermined basis by all members of the group.

It is generally accepted that the following benefits are derived from third party or outsourced insurance (Harrington *et al.*, 1999: 195-196):

- Since it involves the bundling together of many other organisations coverage requirements, preferential rates may be obtained.
- Insurance will reduce the possibility of the administrator needing to obtain additional capital to cover significant losses. This will reduce the likelihood of having to incur finance costs and missing investment opportunities.

Three other techniques that require further elaboration include re-insurance, hedging and diversification:

- **Reinsurance:** Reinsurance is aimed at protecting the administrator of the medical scheme against insolvency or possible significant losses which it itself cannot effectively address by means of self-insurance (Pickford, 2000: 262). Reinsurance involves transferring part or all of the risk to another insurer (Valsamakis *et al.*, 2000: 234). In the international insurance industry a number of differing reinsurance types exist (Vaughn *et al.*, 1996: 150–152). The most common type of reinsurance contract found in the medical scheme environment is the excess-loss treaty or better known

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as a stop-loss agreement (Vaughn *et al.*, 1996: 151). This insurance contract provides cover for a specific risk or covers many risks incurred during a single event. In the case of a stop-loss agreement, the reinsurer will be required to pay after the insured has sustained a loss in excess of a set limit. There is of course a designated maximum of liability for the reinsurer (*ibid.*).

A study was conducted in 2000 for the Registrar of Medical Schemes (The use of reinsurance in medical schemes, 2000). The purpose of the study was to investigate the increased use of reinsurance within medical schemes and whether such arrangements were being utilised to the disadvantage of scheme solvency requirements and members of the medical scheme. The salient findings of the report included:

- In the majority of cases reinsurance was not determined based on valid actuarial computations;
- major conflicts of interest existed between the scheme's trustees and the reinsurer;
- many of the reinsurance agreements reviewed appeared to be little more than contracts used to transfer surplus funds out of schemes; and
- over the period 1996 to 1999, less than 5% of reinsurance agreements improved the underwriting position of the medical schemes.

Based on these findings, the report listed the following key recommendations:

- A formalised definition of reinsurance be set, viz.:  
*"It is a transaction in which the insurer agrees, for a premium, to indemnify a medical scheme against all or part of the loss that such medical scheme may sustain in terms of carrying on the business of a medical scheme."*

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- A medical scheme may not enter into any agreement of reinsurance that has not been approved by the Council of Medical Schemes.
- A medical scheme must obtain authorisation from the Council for any changes to an existing reinsurance agreement.
- Financial statements must be provided to the Council detailing certain key information before the agreement is permitted.
- The Council will only approve a reinsurance contract where there is a spreading of risk, the agreement is in the member's interest, there is no conflict of interest between the parties concerned and the scheme is exposed to identifiable risk of an unusual nature.

The intention is to include these proposed changes as part of the revised regulations associated to the Medical Schemes Act.

- *Hedging*

Hedging involves a strategy designed to reduce or eliminate financial risk. It forms part of the administrator's derivative strategy (Davidson, 2000: 4). The most common types of financial risks that are hedged in the medical scheme environment are (Harrington *et al.*, 1999: 320-321):

- Foreign exchange volatility; and
- interest rate fluctuations.

- *Diversification*

Organisations diversify their operations by acquiring or investing in other companies or by adopting new project initiatives (Harrington *et al.*, 1999: 321-322). The prevalence of joint ventures is a good example of such initiatives.

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In the medical scheme environment the administrator may opt to enter into such ventures with an information technology partner to expedite the electronic transfer of member claims and ensure their effective processing (Editorial 2000).

Although diversification initiatives can reduce the variability of the administrator's cash flow, it is possible that the benefits could be overshadowed by poor resource allocation and lack of manageability. This is especially true in operations where the administrator has no previous experience (Harrington *et al.*, 1999: 321-323).

Overall, it is important that the administrator revisit the approved risk management strategies to ensure they remain appropriate and that they are effective as part of the corporate risk management methodology (De Loach, 2000: 129).

### **8.6 Corporate risk management in South Africa**

Results of the local survey are featured below. These results relate specifically to the elements of common language, risk strategies and tolerances within the corporate risk management programme:

Scales applied in the empirical study were as follows:

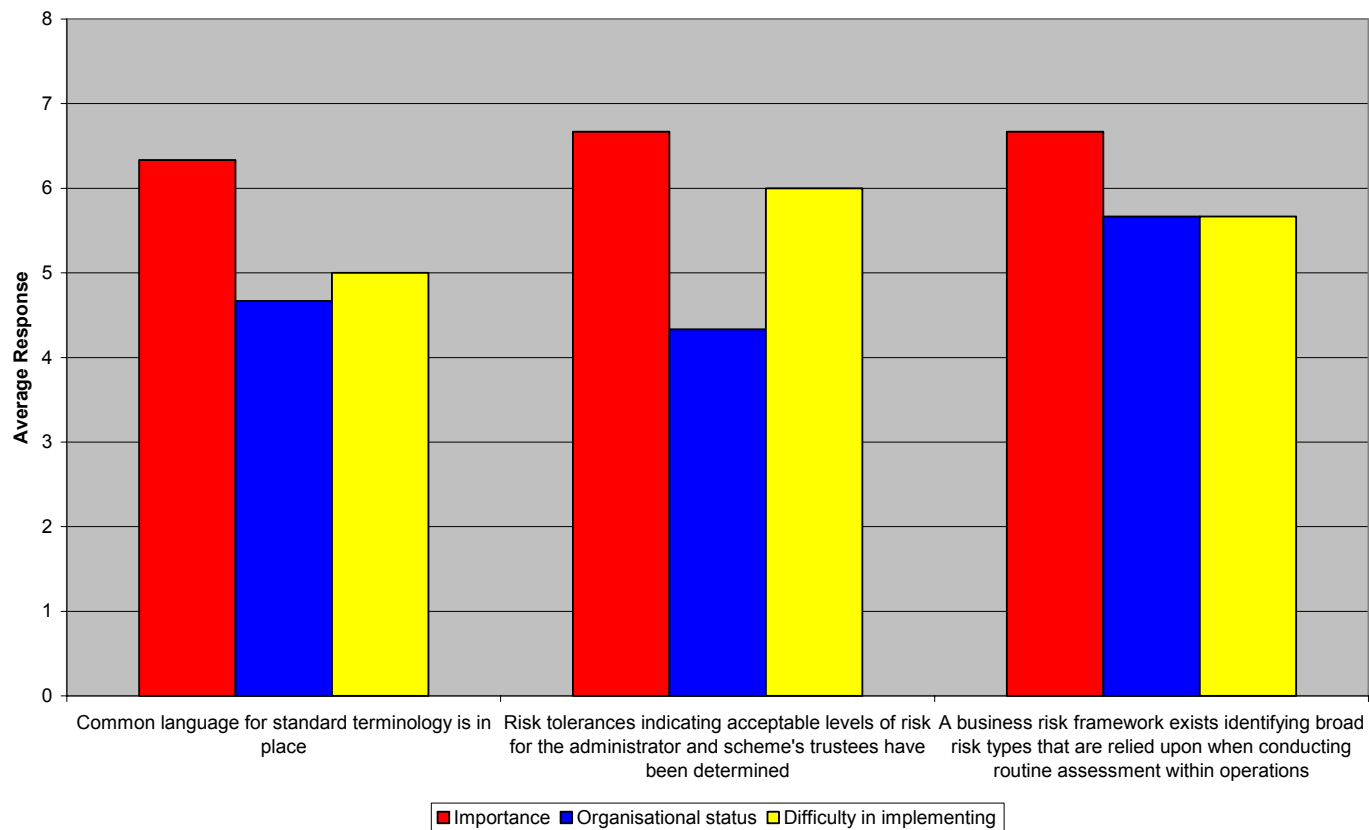
<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
<i>Organisational Status</i>	>8 = Managed/optimised.....7.....6 = defined.....5.....4..... 3 = repeatable.....2.....1 = initial/rudimentary
<i>Difficulty in Implementing</i>	>8 = 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

Based on the below mentioned responses, the most noteworthy issues raised include:

- Respondents rated both the need for a defined common language and approved risk tolerances as relatively important. Of these two issues, the implementation of risk tolerances is considered the most difficult. All respondents progressed poorly in implementing the elements of common language and risk tolerance levels.
- The utilisation of a risk framework to assist in ensuring that all potential risks are identified is also considered fundamental. Organisations believed they had progressed well in implementation.

**Figure 8.4: Empirical study results: common language phase**

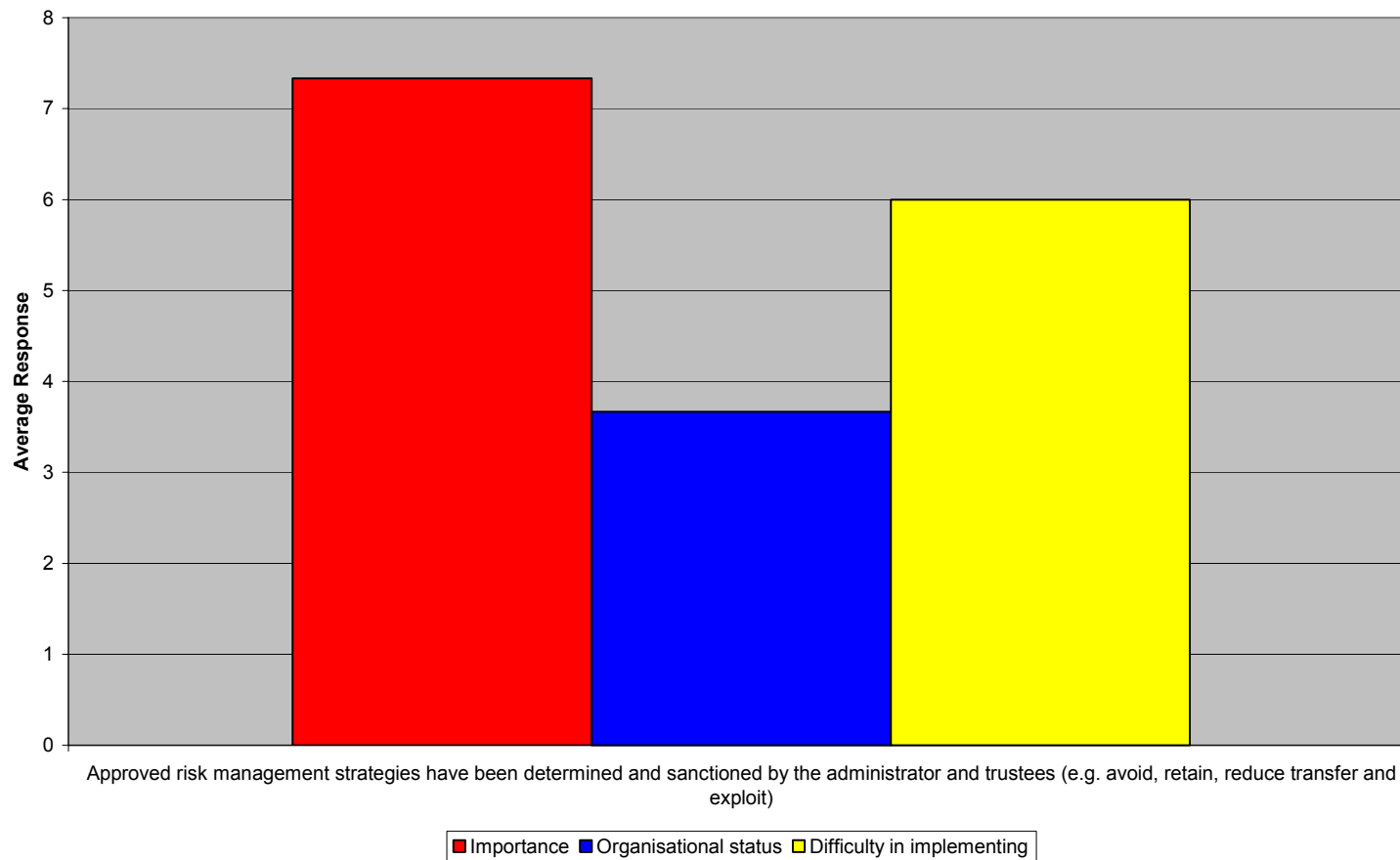
*Criteria below detail the action steps followed within the adoption of the common language phase of a corporate risk management programme*





**Figure 8.5: Empirical study results: risk management strategies phase**

*Criteria below detail the action steps followed within the establishing of the risk management strategies phase of a corporate risk management programme*



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- Approved risk management strategies were considered essential in ensuring that trustee and senior management expectations are met when addressing unacceptable levels of risk. Respondents progressed poorly in introducing such strategies since it is considered relatively difficult in implementing such standards.

### **8.7 Summary**

The chapter introduces the key phases of common language, risk tolerances and strategies.

In terms of common language, the reader is provided with detail on the required starting blocks in setting-up a common language dictionary as well as a suggested risk framework that is applicable in the medical scheme environment. Such a framework would provide assurance that key risk types are identified and suitably assessed.

The chapter provides guidance on the setting of maximum and approved tolerances by defining the most common types of exposure, which a medical scheme can face. The difference between maximum and approved tolerances is also discussed.

One of the key traits of corporate risk management, viz. risk aggregation is also introduced. This concept focuses on applying risk strategies to pooled risks as opposed to individual risks encountered within the medical scheme. The most significant risk management strategies applicable within the medical scheme environment are identified as:

- *Risk rejection strategies*
  - Avoid
- *Risk acceptance strategies*
  - Retain
  - Reduce
  - Transfer

The following significant issues are identified by the empirical study conducted:

- The respondents rated both the need for a defined common language and approved risk tolerances as relatively important.
- The utilisation of a risk framework to assist in ensuring that all potential risks are identified is considered fundamental.
- Approved risk management strategies are considered essential in ensuring that trustee and senior management expectations are met when addressing unacceptable levels of risk. Respondents progressed poorly in introducing such strategies since it is considered relatively difficult in implementing such standards.

### 8.8 Conclusion

The degree of immense change occurring today, the complexity of this change and the lightning speed at which it is occurring is resulting in increased uncertainty. The medical scheme administrator is not immune to this uncertainty and will need to ensure that their risk management methodology includes the necessary phases to ensure that risk exposures are offset or capitalised upon. As part of this, the elements of common language, tolerances and risk management strategies are key stages in ensuring this flexibility.

In an era where risk is perceived to be the driver of organisational activity, the entrenchment of these phases will in turn set off the process towards ensuring that risks are optimally managed. The following chapter introduces two additional phases of the corporate risk management methodology, viz. uniform process development and facilitation.

# Chapter 9

## Uniform Process and Facilitation

It's the constant and determined effort that breaks  
down resistance, sweeps away all obstacles

Claude Bristol

Without everybody embracing what  
we want to do, we haven't got a prayer

Jack Welch

## **9.1 Introduction**

Subsequent to establishing the risk management strategies, tolerances and the common risk management language, it is necessary that the organisation defines a uniform process for corporate risk management and develops the skills of facilitation.

This uniform process will vary from industry to industry but should include certain fundamental elements to ensure best practice and that the corporate risk management initiative is a success. Uniformity should provide all stakeholders with increased confidence that risks are being suitably managed and provide flexibility to act on exposures in a timely fashion (De Loach, 2000: 115).

Facilitation skills will be necessary to aid the operation of the uniform process and ensure that accurate and comprehensive risk management results are obtained.

## **9.2 Aim**

This chapter will aim at providing the reader with a uniform process that may be applied within a healthcare administration organisation as well as detail on each of the process's elements.

Suitable facilitation techniques will also be introduced and described.

### 9.3 Uniform process

Based upon an assessment of current risk management literature, most corporate risk management processes include the phases of risk identification, quantification and ongoing management. Figure 9.1 below depicts a suggested uniform process that may be applied by management within a healthcare administration organisation. The following sources were relied upon in developing the suggested process:

- De Loach, 2000
- Discovery, 2001
- IFAC, 1999
- King Committee, 2002
- Valsamakis *et al.*, 2000.

By implementing a uniform process, the administrator will obtain assurance that risks are defined within the context of its critical processes and that key risks are not overlooked.

As emphasised by figure 9.1, the uniform process is ongoing. Its ongoing nature ensures that existing risks are re-evaluated and that new exposures are identified timeously. The frequency with which the assessment should be conducted will be dependent on the needs of the healthcare administrator and the business criticality of the operations being assessed.

Figure 9.1: Uniform process



### 9.3.1 Identify

Once the healthcare administrator has focused on establishing an environment that engenders a common language, the risk management function should assist management in identifying exposures. It is important to note that one particular method of risk identification will, in most instances, be insufficient. It is recommended that management employ a combination of techniques in order to ensure that the identification process is comprehensive and adds value (Valsamakis *et al.*, 2000: 92). Of the tools that could assist the process owner in identifying key risks, the following methods will be discussed:

- *Risk brainstorming*: This is considered to be the most widely deployed tool for risk identification (De Loach, 2000: 118). Depending on the risk maturity of the management team, the risk management function could decide to apply a generic risk

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framework in the initial stages of the identification process. The suggested framework will act as a guide to management in ensuring that key risks are not bypassed. A framework similar to that identified in figure 8.1 of chapter 8 could be applied. The only requirement that should be adhered to during such sessions is identified risks being linkable to the medical scheme's strategic and operational objectives.

- *Scenario planning*: Scenarios have been called *strategic conversations* (McNamee *et al.*, 1998: 52). The reason for this is that management utilise scenarios to discuss their current plans, examine current results against possible futures and explore the risks and opportunities that may occur. Four distinct types of scenario planning may be applied within the healthcare environment:
  - *Planning narrative*: Single future scenarios that attempt to explore assumptions in-depth, enabling managers to make better decisions regarding new project investments. The time horizon is usually the project's useful life (*ibid.*).
  - *Threat scenarios*: Used to examine possible future events focused on a particular asset risk exposure. The time horizon is often indeterminate.
  - *Risk scenarios*: The use of scenarios to explore the risks in an actual situation along with a version that is less optimistic and one that is more optimistic. The time horizon is often less than 5 years. This type of planning is the most common form applied. Common considerations that may be applied when defining risk items include (Illbury *et al.*, 2001: 131):
    - Consider the existence and effect of external governing factors such as laws and regulations; etc.
    - Uncertainties which exist; and
    - Possible solutions and decisions, which are plausible.

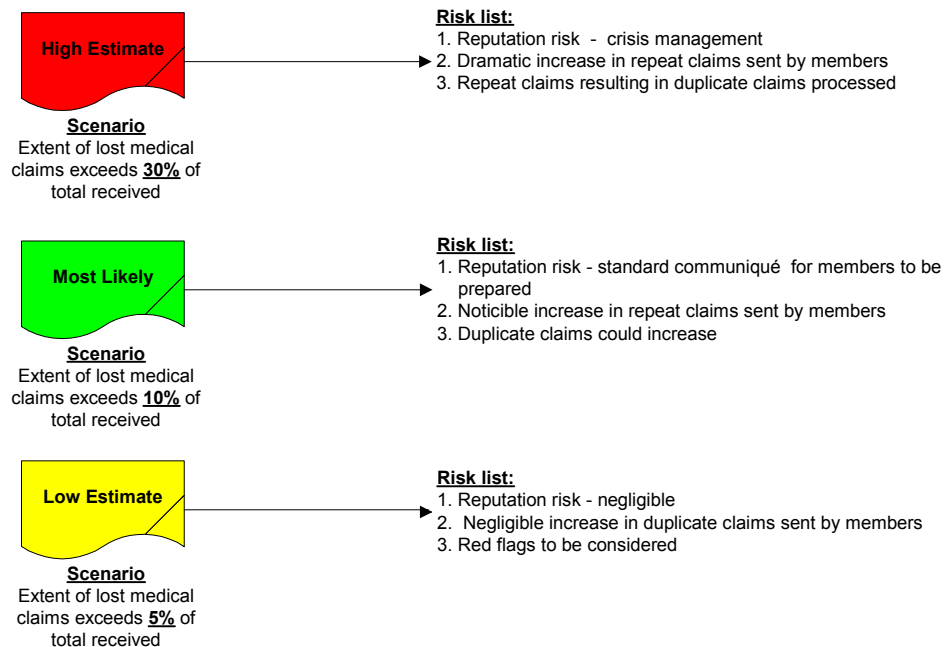
Figure 9.2 provides an example on where risk scenario planning is applied on the issue of lost medical claims.



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- *Strategic scenarios*: Planning scenarios in sets of four or more equally plausible futures that have time horizons of 5, 20 or more years.

**Figure 9.2: Risk scenarios: lost medical claims**



Risk awareness is achieved by ensuring that the management team considers the process of risk identification as ongoing and not a once off exercise. Management will need to consider techniques for ensuring that momentum is retained and that buy-in is ensured.

Once the risks have been identified the process of source analysis can take place.

### 9.3.2 Source analysis

Source analysis is the focused evaluation of why, how and where exposures can happen. This is achieved by classifying risks identified into one of the categories included under in table 6.2 of chapter 6, viz.:

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<i>Inherent Risks:</i>	Risks that have a direct impact on the operating profit of an organisation, i.e. offensive in nature.
<i>Incidental Risks:</i>	Risks that do not form part of the main business operations but are necessary to ensure continuity of operations, i.e. hedging in nature.
<i>Systemic Risks:</i>	Risks that have no potential for showing a profit, i.e. defensive in nature.

This classification process will assist in ascertaining which risks are driven by external or internal factors (De Loach, 2000: 118). This will in turn provide management with the ability to select the most appropriate risk management strategy once the risk has been suitably quantified and evaluated.

To ensure that exposures and areas of opportunity are addressed, it is also necessary to ensure that owners for each of the key risks are identified. This will assist management in expediting the management phase of the uniform process discussed later.

### 9.3.3 Quantify

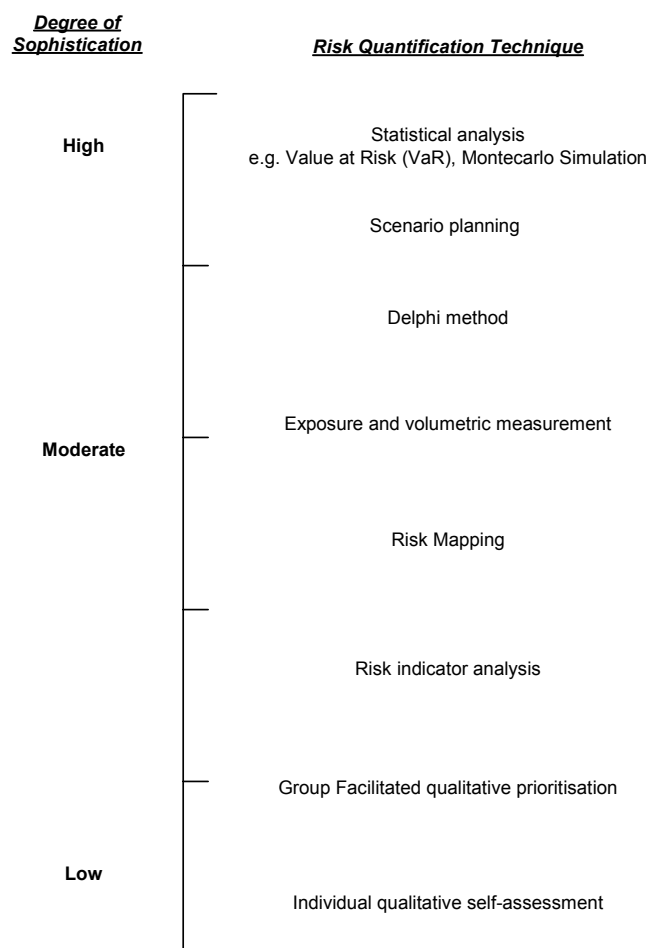
The quantification of risk is a difficult practice (Pickford, 2001: 41). The quantification process may vary in sophistication. This level of sophistication will usually be driven by 5 factors (ibid):

- Severity and increased volatility of the risk being assessed;
- complexity;
- availability of information;
- the purpose for which the risk quantification will be used; and
- cost of the quantification technique.

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Figure 9.3 (adapted from De Loach, 2000: 128) provides an indication of the varying types of risk quantification based on increased levels of sophistication. In addition to the varying degrees of sophistication, subjectivity within the quantification process is affected by the degree of skill of the risk management function as well as the extent to which collaborative techniques are applied. In instances where collaborative or group facilitation techniques are applied it is imperative that the risk management team understand the workings of the healthcare unit being assessed. This will ensure acceptance by participants. Section 9.4 of this chapter will deal with facilitation in more detail.

**Figure 9.3: Quantification techniques by degree of sophistication**



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Details on the other forms of quantitative techniques include:

- *Risk indicator analysis:* This technique utilises decision aids to assist users in identifying and evaluating qualitative risk factors. Decision aids typically provide a summary of questions that depending on the response suggest possible symptoms.
- *Risk mapping:* Assessment of risk based on likelihood and consequence.
- *Exposure and volumetric measurement:* What the cost or benefit of the risk is after all likely risk transfer strategies and opportunity exploitations have been considered.
- *Delphi method:* Appointment of a panel of experts to consider possible risks and associated measures. The subsequent co-ordination of results to prepare a composite list that is then returned to the experts for comparison with their initial lists.

Once the score has been determined for each of the risk items, it is necessary that this be offset against the approved tolerances.

#### 9.3.4 Evaluate

You may recall from section 8.4 of chapter 8 that the trustees of the medical scheme, in conjunction with senior management, will set the maximum risk tolerance levels or capacities to bear risk. These tolerances indicate where return on investment is maximised and where no further risk management strategies are required to address unacceptable levels of risk. Tolerances are set per risk type and sanctioned by the risk committee.

The predetermined risk tolerances are then offset against the actual residual risk scores for each of the items being assessed. In instances where the actual risk score, after considering the effectiveness and frequency of controls and other management initiatives, exceeds acceptable tolerances, an event is noted. This event then forms the basis of introducing the next element of the uniform process, viz. manage.

### 9.3.5 Manage

The methods selected to address events will depend upon the cost of each method and its effect on the expected cost and variability of losses (Harrington *et al.*, 1999: 13). The corporate risk management policy should define management's position regarding flexibility within the decision-making process.

Should management utilise the risk mapping quantitative technique as a means of evaluating the extent of each risk, a management model similar to that in figure 9.4 may be applied (Treasury Board of Canada, 2001: 32).

**Figure 9.4: Suggested management model when utilising risk mapping**

<b>Consequence</b>	<b>Risk Management Actions</b>		
	<b>Significant</b>	Considerable management required	Must manage and monitor risks
<b>Moderate</b>	Accept, but monitor risks	Management effort worthwhile	Management effort required
<b>Minor</b>	Accept risks	Accept, but monitor risks	Manage and monitor risks
	<b>Low</b>	<b>Medium</b>	<b>High</b>
	<b>Likelihood</b>		

The management of events includes a number of distinct phases. These phases are described below:

- *Develop action plans:* The various risk management strategies available to the administrator are included under section 8.5 of chapter 8 of this study. As mentioned in section 9.3.3 of this chapter, management in conjunction with risk management personnel will focus on ensuring that the size of potential losses, their probability, and the availability of resources are considered when selecting the most appropriate strategy. In addition to this, a number of other factors will assist management during the selection process:
- *Time variability:* This will attempt to categorise the various risk exposures according to a predefined time scale, e.g. short, medium and long-term. Defining risk according to such a scale should ensure that the most appropriate strategy is selected to address the extent of the risk over time. Any mismatch between the duration of the exposure and the length of time that management needs to implement a suitable strategy could result in unnecessary losses to the administrator and the loss of support for the corporate risk management initiative.
- *Tolerances:* Risk exposures in most instances cannot be eliminated in totality. Management should seek feasible solutions that hold risks at tolerable levels while ensuring that business objectives are achieved optimally.
- *Prioritisation:* Management should attempt to focus on areas where the quickest impact can be made with the least amount of resources. For example, the administrator could reduce unacceptable levels of risk by implementing effective management controls not previously considered. This does not mean that management should avoid longer-term exposures but that they should focus on areas that require minimal effort to improve overall control.
- *Information availability:* As discussed in section 7.4.4 of chapter 7, the availability of suitable information is necessary to ensure the success

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of the corporate risk management initiative. The availability of suitable information may be assisted by the implementation of a data warehouse (Dowd, 2001: 232-233). This type of application can aid management by providing various trends on key transaction types. These trends are obtained by processing large volumes of claim or premium data through the data warehouse environment. With regard to development, the data warehouse environment should be implemented according to the Administrator's approved project management methodology.

- *Allocate resources based on owner responsibilities:* Once exposures that require management have been identified, it then becomes the responsibility of the risk owner to resolve these anomalies. You may recall that the risk owner was identified during the source analysis phase of the uniform process discussed earlier.
- *Follow-up of high risks and escalate feedback:* This stage ensures that significant anomalies are not forgotten and that unresolved action points are escalated to senior management for further follow-up.

**9.4. Facilitation****9.4.1 Facilitation techniques**

As mentioned in table 7.1 of chapter 7, the chief risk officer, with the assistance of his risk management specialists, will act as business management's coach in assisting them in designing and implementing the corporate risk management architecture. To achieve this, they will require the use of flexible facilitation methods. Such methods require advance preparation and a structured approach to maximise chances of success (De Loach, 2001: 120).

Facilitation is defined as a method used to assist a group in achieving a common goal or aim (Cameron, 2001: 1-2).

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Key roles and responsibilities of personnel conducting such facilitation activities include (Cameron, 2001: 2-3):

- Ensuring that there is a clear risk management aim;
- ensuring that the right participants are involved;
- ensuring that sufficient planning is conducted before facilitation is initiated;
- ensuring that the facilitation process displays sufficient rigour;
- accurately recording and disseminating facilitation results; and
- ensuring good quality follow-up after the facilitation process as a means of identifying possible areas of improvement.

Choosing the correct facilitator assists in achieving an effective risk management programme. For this reason, the role of facilitation should be assigned to individuals who have previous experience in facilitation and have sufficient maturity to handle the various levels of management that will participate in the facilitation process. (Arthur Andersen, 2000).

The following three facilitation methods may be applied in the uniform risk management process (Arthur Andersen, 2000):

- *Group meetings*: This entails group meetings with the possible utilisation of voting technology. It is a useful approach when the business unit being assisted is interested in taking over risk assessment responsibilities but is reluctant to invest too much time or money initially. The specialist develops the topics for discussion, facilitates the meeting and analyses the results. Some guidelines relating to such facilitated group meetings include:
  - Participants attend as they have a contribution to make;
  - the meeting is run according to a pre-circulated agenda;
  - openness during all discussions is encouraged;
  - the facilitated meeting forms part of a larger process and everyone is informed of its progress;
  - keeping to the meeting agenda without major deviations;



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- always portraying a servant mentality in the group environment as opposed to a master mentality;
- learn to recognise and rely on non-verbal messages;
- end on a positive note; and
- additional responsibilities of the facilitator include (Dibble *et al.*, 1994: 97-104):
  - Noting when participant interest or energy is low;
  - noting when the meeting agenda is less effective and requires adjustment; and
  - noting when the group dynamic is poor and attendee participation needs to be reconsidered.
  
- *One-on-One interviews*: One-on-one interviews will be beneficial if the people that need to be interviewed are in various geographic locations. Interviews are also useful if there is a chance that the participants will not express their candid opinions in an open meeting. The specialist develops the questions, conducts the interview and analyses the results.
  
- *Survey*: Self-assessment surveys may be used as a transition tool to introduce the self-assessment concept to the company. The specialist develops the questionnaire, summarises and analyses the results. Guidelines to preparing suitable surveys include (Ferreira *et al.*, 2002: 12-15):
  - Questions should be in the recipients preferred language;
  - questions should be short and simple and addressed in a personal manner;
  - questions should be information orientated and should not be designed to place blame; and
  - feedback from the survey process is obtained as a means of identifying possible areas of improvement.

#### 9.4.2 Facilitation in action

The selection of the most appropriate facilitation technique is key to ensuring buy-in into the overall corporate risk management initiative (Arthur Andersen, 2000).

In selecting the most appropriate facilitation technique, the risk management specialist should consider the environment in which the risk assessment is being conducted. Generally, group meetings require the largest degree of openness to ensure success, whereas survey based facilitation is more suited for a bureaucratic management environment. The following factors should be considered before a suitable facilitation technique is selected (ibid.):

- The organisation values empowerment, employee participation, openness and continuous improvement;
- the organisational culture can tolerate a reasonable degree of candidness;
- the organisation is ready for the kind of information the self-assessment approach may generate; and
- employees have a reasonable degree of safety, i.e. can they talk openly about what they feel regarding the current controls?

In risk management functions where the availability of qualified facilitators is a problem, the most talented should initiate the process by conducting one-on-one interviews and surveys and obtaining suitable external training until sufficient experience and courage is obtained. The utilisation of consultants to assist in transferring the facilitation techniques should also be considered. Facilitation skills can be taught, and they can be taught to nearly everyone. The so-called "natural facilitator" may exist, but the training courses available today are effective with the full range of personalities.

### 9.5. Corporate risk management in South Africa

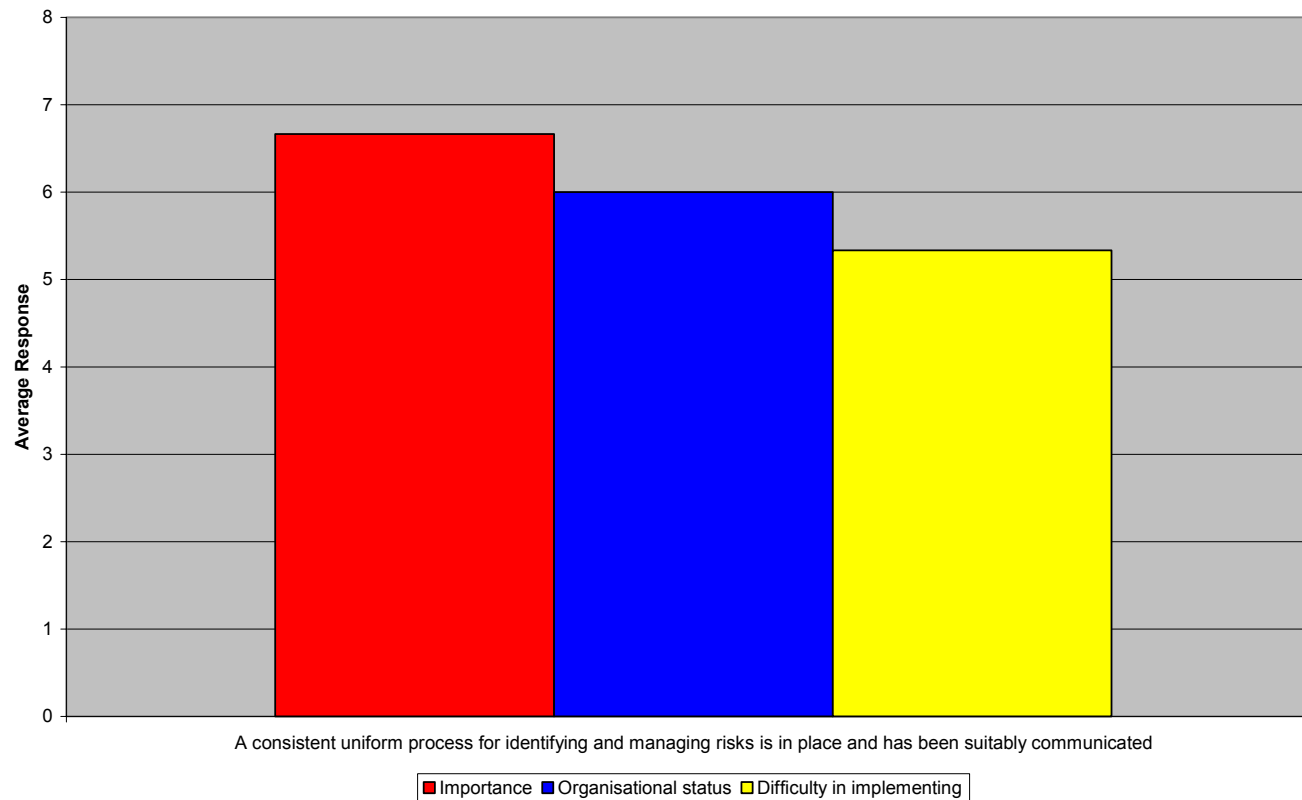
Results of the local survey are featured below. These results relate specifically to the element of uniform process and quantification techniques applied within the corporate risk management programme:

Scales applied in the empirical study were as follows:

<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
<i>Organisational Status</i>	>8 = Managed/optimised.....7.....6 = defined.....5.....4..... 3 = repeatable.....2.....1 = initial/rudimentary
<i>Difficulty in Implementing</i>	>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

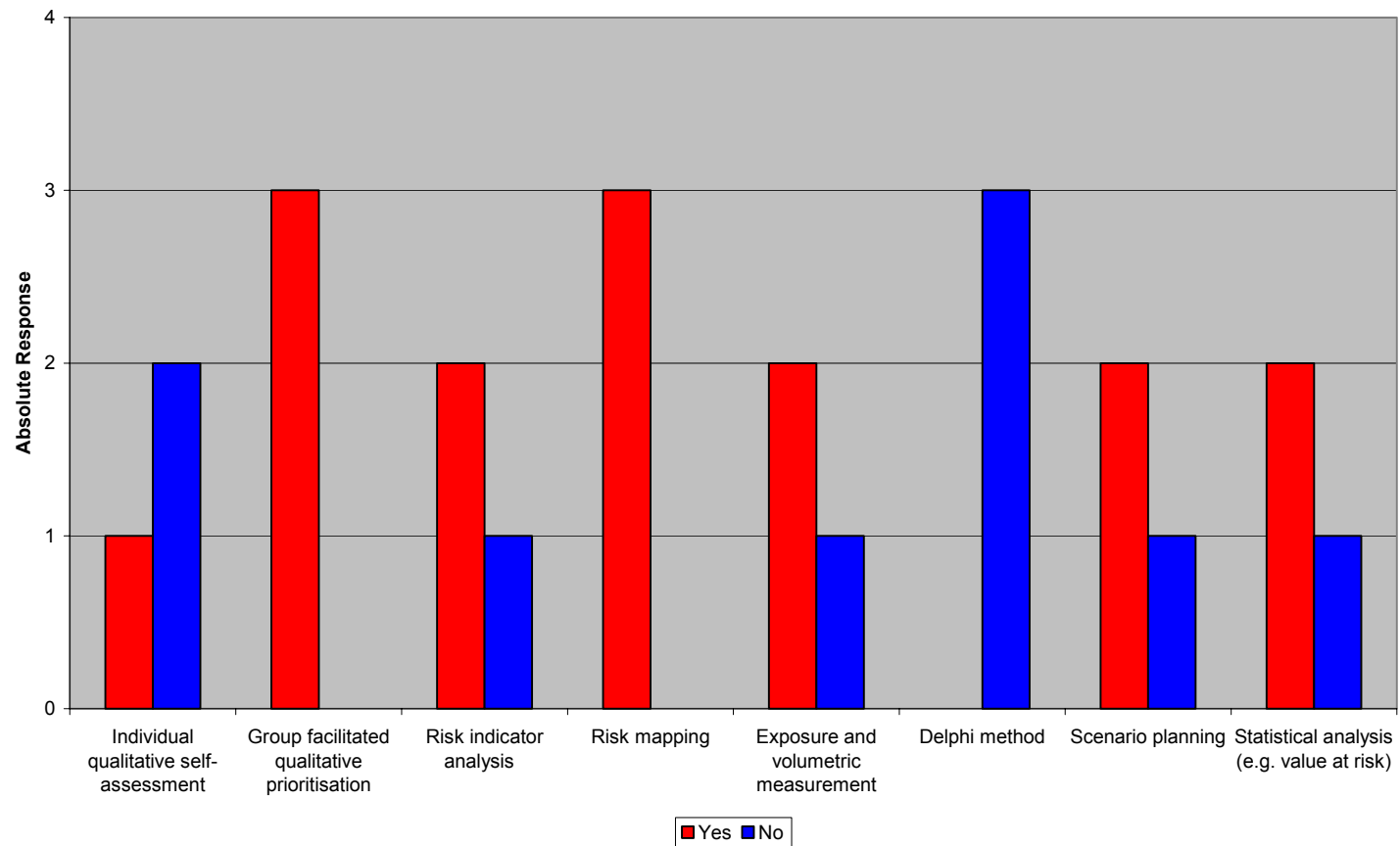
**Figure 9.5: Empirical study results: uniform process phase**

*Criteria below detail the action steps followed within the adoption of uniform process phase of a corporate risk management programme.*



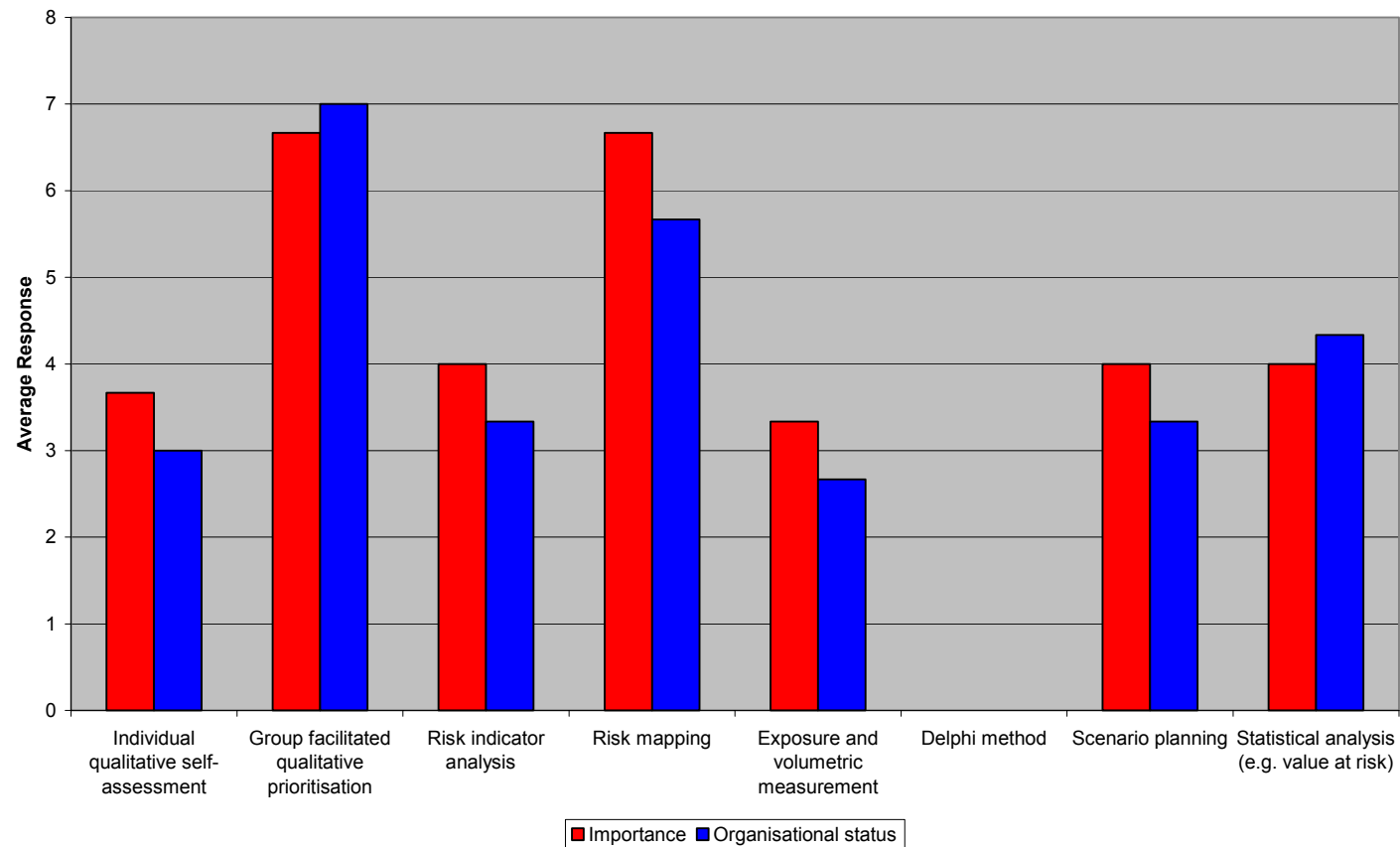
**Figure 9.6: Empirical study results: extent of risk quantification techniques**

*In quantifying the extent of risk, which types of risk quantification techniques are used?*



**Figure 9.7: Empirical study results: importance and organisational status of risk quantification techniques**

*The importance of the various types of risk quantification techniques and their utilisation status within the industry*



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Based on the abovementioned responses, the most noteworthy issues raised include:

- Respondents concurred that a need existed for a consistent risk management process. It was pleasing to note that respondents believed they had made significant inroads in adopting a uniform process even though it was considered relatively difficult in implementing.
- The most utilised risk quantification techniques included group facilitated qualitative prioritisation and risk mapping. The group-facilitated technique was the most advanced in terms of implementation status within healthcare administration organisations.
- The delphi method was not applied by any of the respondents as a means of quantifying risk.

**9.6 Summary**

Chapter 9 introduces the concept of a uniform risk management process, which includes the key phases of identification, source analysis, quantification, evaluation and management:

- *Identification:* Risk mapping and scenario planning are highlighted as techniques, which could be used in identifying key risks.
- *Source analysis:* Source analysis is the focused evaluation of why, how and where exposures may happen. This classification process will assist in ascertaining which risks are driven by external or internal factors
- *Quantification:* Common quantification techniques include:
  - Group facilitated qualitative prioritisation;
  - individual qualitative self-assessment;
  - risk mapping;
  - risk indicator analysis;
  - exposure and volumetric measurement;
  - statistical analysis; and
  - scenario planning

The quantification process may vary in sophistication. This degree of sophistication is driven by a selection of factors.

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- *Evaluation:* Concerned with the plotting of risk exposures against approved tolerances and the identification of unacceptable levels of remaining risk.
- *Management:* The development of suitable action plans, allocation of resources to address risk exposures and the suitable follow-up of significant risk issues.

The use of group meetings, surveys and one-on-one interviews are introduced as facilitation techniques in aiding the uniform process. The key roles and responsibilities of the facilitator are also introduced.

The following significant issues are identified from the empirical study conducted:

- Respondents believed they had made significant inroads in adopting a uniform process within their own organisations; and
- the most utilised risk quantification techniques included group facilitated qualitative prioritisation and risk mapping.

### **9.7 Conclusion**

A uniform process will better equip management to identify the exposures, sources of uncertainty and opportunities thereby allowing for improved value adding to all key operations within the healthcare administration organisation.

The reason for the uniform process being of such paramount importance within the corporate risk management methodology is that suitable risk management strategies cannot be applied until the healthcare administrator has identified and understands the source of risks and has suitably quantified the extent of the relevant exposures.

The role of facilitation in lubricating the uniform process should not be underestimated. Effective facilitation will ensure that complete and accurate risk management inputs are obtained and converted into meaningful



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information for the trustees and senior management team of the medical scheme.

# Chapter 10

## Project Management and Continuous Improvement

We are what we repeatedly do.  
Excellence then, is not an act, but a habit

Aristotle 384 - 322 BC

He that will not apply new remedies must  
expect new evils, for time is the greatest innovator

Francis Bacon 1561-1626

## **10.1 Introduction**

Once the healthcare administrator has devised a uniform process, it is necessary that the business risk management function assists in the roll-out of the methodology and in ensuring that current practices are continually improved.

The project management process requires a combination of techniques whereas the continuous improvement phase requires the revisiting of the following enablers:

- Suitable information systems;
- consolidated reporting techniques;
- communication and training;
- benchmarking and lessons learnt; and
- objective assessment.

It is necessary that the trustees in consultation with the healthcare administrator focus on continuously streamlining existing processes to ensure appropriateness and that best practice is achieved.

## **10.2 Aim**

The reader will be provided with guidance on how the corporate risk management initiative may be successfully rolled-out to the organisation. In addition to this, recommendations on how the overall corporate risk management initiative can be continuously improved will also be provided.

## **10.3 Project management**

As discussed, corporate risk management is focused on providing a company-wide picture of the aggregated risks faced by the administrator and how these exposures may be effectively managed. This is a formidable task that requires

careful project management. The following considerations should be kept in mind when project managing the implementation of such an initiative:

### 9.3.1 *Business roles*

In addition to the roles defined in section 7.5.2 of chapter 7, it is necessary that a dedicated team be appointed to effectively manage the roll-out of the corporate risk management initiative. The most common types of roles that will be encountered during such an initiative include (Chong, 2000: 114):

- *Project sponsor*: This will usually be the chief risk officer or a representative from senior management who has been tasked with the implementation of the corporate risk management initiative. The project sponsor should receive regular feedback from the project management team on how the project is progressing and what successes or shortfalls could hinder the implementation of the methodology.
- *Project manager*: The project manager ensures the optimal utilisation of project resources and skills thereby making certain that the project objectives, as approved by the project sponsor, are effectively achieved within acceptable time frames. The project manager should keep control over any project infighting since a good team culture is crucial.
- *Risk experts and consultants*: It is recommended that a risk expert be requested to provide ad hoc input during the project process. Positive criticisms will ensure that the corporate risk management methodology complies with best practice and that suggested enhancements by the organisation do not contravene corporate governance standards.
- *Team participants*: The remaining participants should consist of a combination of personnel who can add value to the project. Usually this involves a combination of personnel from the key operational processes, internal audit, the external auditors and any other assurance services within the organisation.

### 9.3.2 *Project Piloting*

In its simplest form, project piloting enables management and the trustees to get an early glimpse of how the final corporate risk management process will operate (Chong, 2000: 22). Operationally, piloting will involve the isolation of one business unit over which the entire corporate risk management methodology is rolled-out. This provides for a number of benefits (ibid.):

- Acts as a model to the trustees and senior management on what may be expected once corporate risk management is rolled-out to all the administration functions;
- provides an opportunity for mistakes to be made without significant cost to the organisation;
- allows for the risk management methodology to be tweaked, meeting the unique needs of the organisation; and
- may act as a means of convincing the trustees and management that corporate risk management can reduce the extent of unforeseen exposures.

### 9.3.3 *Resourcing*

Vital to the success of the project is the need for specifically allocated resources. These resources usually include:

- Dedicated human resources such as that of a project management team;
- monetary support;
- information systems and technical support; and
- significant time from all business units and in the case of a pilot, the attention of all personnel within the associated functions in which the pilot is being run.

### 9.3.4 *Post implementation reviewing*

As with all strategic initiatives, it is necessary that a review be conducted after the implementation of the corporate risk management

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programme to ensure that the expected benefits of such a programme are realised. This involves some form of post implementation review. The standard post implementation process should consider the following (Marcella *et al.*, 2001: 297-299):

- The review should take place three to six months after the implementation of the corporate risk management programme;
- persons integrally involved in the project should not be allowed to conduct the post implementation review; and
- a final report should be presented to the project sponsor and senior executive on whether the expected benefits were realised.

The benefits that should be realised should include those identified in section 4.4 of chapter 4.

**10.4 Continuous improvement**

It is necessary that as the administration organisation achieves its corporate risk management goals, senior management, in conjunction with the trustees, look at ways of continuously streamlining the process. Below are some considerations that may assist in achieving this:

**10.4.1 Suitable information systems**

In chapter 7 section 7.4.4 it was indicated that one of the key elements of a risk management programme was the need for up to date systems and data. To ensure continuous improvement within this process, the following are necessary:

- As business processes change over time within the administration function, senior management should check that existing systems are utilising the correct data when providing management with key information. This will ensure that information relied upon is accurate and reliable.
- Risk reports are revised on an ongoing basis to ensure that they provide accurate information on the level of exposure versus limits

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and trends in tolerance violations. It is imperative that personnel with risk management responsibilities use reports to monitor achievement of objectives, execution of risk management strategies and compliance with the corporate risk management policy on an ongoing basis.

*10.4.2 Consolidated reporting*

A number of local and international software companies have developed corporate risk management software to meet the needs of organisations which have embarked on the risk management journey. Corporate risk management software is effective in situations where risk management initiatives have been operating effectively for a period of time and where key internal customers are satisfied with the existing manual or semi-manual process.

Existing software packages provide the user with the following key functionality:

- Permits the user to define the organisational structure thereby allowing risk management results to be presented at various levels within the business;
- ability to redefine the uniform process as the needs of the organisation is updated;
- allows for the development of a risk repository that includes all known risks faced by the organisation over time. This is a powerful tool that can assist in scenarios planning;
- allows for web-enabled completion of risk assessments by operational personnel; and
- provides extensive graphing and reporting functionality that can summarise and depict key risk exposures for senior executives and the trustees of the medical scheme.

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Although the population and configuration of such software is time consuming, such software may provide untold value to the trustees and senior management of the administration function.

#### 10.4.3 *Communication and training*

The buy-in of all personnel during the roll-out and continuous operation of the corporate risk management initiative is key. In chapter 7 reference was made to the establishment of a communication strategy that would clarify basic risk management terminology, roles and responsibilities, awareness regarding the risk management policy and associated procedures.

To ensure that buy-in is maintained at a consistent level, it is necessary that this communication strategy be revisited on an ongoing basis and that the skills of all affected personnel are developed over time. As personnel take on new risk management responsibilities, their roles, accountability and relationships with other risk owners should also be updated to address the ongoing developments within the corporate risk management programme.

Also, a risk does exist that the roles and responsibilities of risk taking versus risk monitoring may become blurred over time. It is imperative that communication and training initiatives highlight the difference in these roles and that strategies are implemented to avoid confusion (De Loach, 2001: 151).

#### 10.4.4 *Benchmarking and lessons learnt*

Continuous improvement and lessons learnt involves the process of benchmarking current risk management practices. Benchmarking is defined as the comparison between internal processes and those of competitors or best class organisations (De Loach, 2000: 182). In instances where current risk management practices vary from such benchmarks, the trustees, in conjunction with the administrator, should consider the feasibility in improving such current practices.



Currently in South Africa the larger auditing and accounting firms conduct most forms of benchmarking initiatives relating to risk management and corporate governance. However, in assessing most of these sources available at the time of conducting this study, limited focus was given to the healthcare administration environment<sup>1</sup>.

In instances where the healthcare administrator is sufficiently large to include a number of administration specific processes that are duplicated across a number of geographical locations, internal benchmarking may also be effective.

In an international study conducted regarding trends and emerging practices within the field of corporate risk management across various industries, the following success factors were cited (Tillinghast-Towers Perrin, 2001: xix):

- Strong and visible support from senior management is indispensable;
- employing the services of external consultants to ensure best practice is achieved;
- proceeding incrementally and leverage against early wins;
- introducing corporate risk management as an enhancement to already entrenched and well placed processes within the organisation as opposed to a new and stand alone process; and
- having a dedicated group of cross-functional staff within the corporate risk management team to ensure the distinct needs of each operational function are considered.

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<sup>1</sup> Assumption based on the author's personal evaluation of South African literature relating to risk management:

- KPMG, 1999
- KPMG, 2001

## 10.4.5 Objective assessment

The reader is referred to section 3.5 of chapter 3 for more information regarding the internal auditor's role in the corporate risk management initiative.

## 10.5 Corporate risk management in South Africa

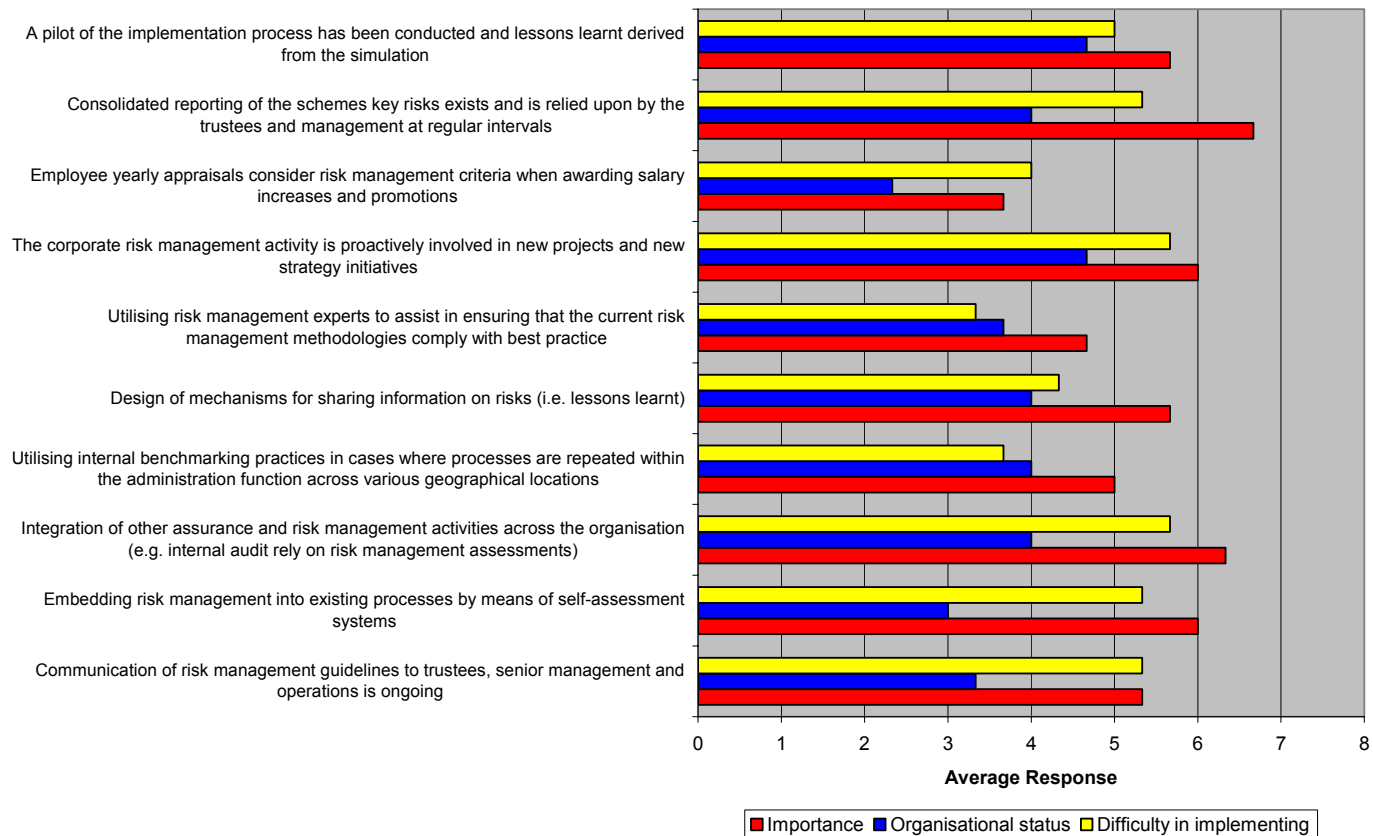
Results of the local survey are featured below. These results relate specifically to the elements of project management and continuous improvement within the corporate risk management programme.

Scales applied in the empirical study were as follows:

<i>Importance</i>	>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2..... 1 = unnecessary.....0 = N/A
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**Figure 10.1: Empirical study results: project management and continuous improvement phase**

*Criteria below detail the action steps followed within the project management and continuous improvement phase of a corporate risk management programme*



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Based on the abovementioned responses, the most noteworthy issues raised include:

- The criteria of consolidated reporting and integration of assurance service functions was of greatest importance. The integration of such assurance service functions was considered to be one of the most difficult elements in implementing.
- Ensuring that the corporate risk management initiative was actively involved in strategic initiatives was the other most difficult element in implementing. However, with regard to implementation within their organisations, respondents indicated that this continuous improvement element was the most advanced.
- The utilisation of external risk management experts was the least important of the continuous improvement elements. It appears that healthcare organisations preferred to improve the corporate risk management processes based on own experience and internal demands from senior management and the medical scheme's trustees.
- The use of pilot projects as a means of obtaining an early glimpse of how the final corporate risk management process would operate was important and could be implemented within a period of three to six months.

## **10.6 Summary**

The phases of project management and continuous improvement, which reflect the last two stages of the corporate risk management methodology, are discussed in this chapter.

Project management includes the following distinct criteria, which are discussed:

- Definition of business roles;
- utilisation of project piloting;
- sufficient resourcing practices; and
- post implementation reviewing.

Continuous improvement is discussed in terms of:

- Suitable information systems;
- consolidated reporting;
- communication and training;
- benchmarking and lessons learnt; and
- objective assessment.

The following significant issues are identified from the empirical study conducted:

- The criteria of consolidated reporting and integration of assurance service functions was of greatest importance in terms of continuous improvement.
- The use of pilot projects as a means of obtaining an early glimpse of how the final corporate risk management process would operate was important and could be implemented within a period of three to six months.

### **10.7 Conclusion**

Due to the vast number of organisational structures and cultural environments, no two healthcare administration organisations will take the same route in implementing corporate risk management.

Various players of the corporate risk management game are at differing levels within the corporate risk management programme. Some will focus on pilot project initiatives while others will look at conducting company-wide risk assessments. It is, however, imperative that since this is a relatively new field of study, members of the healthcare administration organisation focus on early wins that will build momentum and promote further development towards a fully integrated approach.

# Chapter 11

## Conclusion

The average company today is a complex enterprise engulfed by rapid technological change and fierce global competition. You have to assess exposure to risk on an ever changing landscape

Arthur Levitt

Former chairperson of the US Securities Exchange Commission

## **11.1 Summary**

From its insurance origins, corporate risk management has developed into a fully fledged management function and is progressing into business areas that were originally considered unrelated. The evolution of risk management towards a corporate risk approach recognises that risks are interrelated and that significant benefits may be achieved from evaluating and monitoring them on a company-wide basis.

This study aims at providing the reader with information on the key risks facing the private healthcare administration organisation in South Africa as well as suggesting a suitable corporate risk management programme that may be applied. Suggested methodologies and observations are supported by the results of an empirical study representing 22% of the registered medical schemes in South Africa.

The study considers 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 reason why previous risk management techniques have been considered unsuitable is the fact that risks are often assessed in isolation and that the focus has been on their hazardous or downside element.

The study identifies the most significant risks faced by the medical scheme environment as confidentiality, compliance with legislation and ensuring that prescribed member benefits were not exceeded. Respondents to the empirical study consider the highest degree of risk within the medical scheme to be concentrated within the strategic and core operational activities of the medical scheme.

Healthcare administration organisations are on a development continuum with respect to managing risks and creating increased stakeholder value. How far such organisations progress on this continuum and the rate of such change will be dependant on past experiences, structural set-up as well as its desire

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to be world-class. The results of the empirical study indicate that medical schemes utilise a defined risk management process somewhere between the risk and corporate risk management stages on the continuum. For continued success, it is vital that administrators perceive this continuum as a journey and not an event.

Based on an assessment of leading literature the following updated definitions for corporate risk management and risk were set:

- *Corporate risk management*: A structured process of identification, assessment and the continuous management of the combined risks aimed at ensuring stakeholder expectations are achieved.
- *Risk*: A concept used to express uncertainty about all possible future events, which could significantly influence the achievement of the organisation's collective business objectives.

A suggested corporate risk management methodology is introduced which will provide the trustees with greater confidence that risks are being optimally managed. The methodology consists of the following key phases:

- Implementation feasibility;
- adopt goals, objectives and oversight;
- common language;
- risk tolerances;
- risk management strategies;
- uniform process;
- facilitation;
- project management; and
- continuous improvement.

Significant issues identified from the empirical survey include:

- The revision of the King Report on Corporate Governance has increased the importance of corporate risk management.
- A need for a defined corporate risk management philosophy within administration organisations was noted.



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- Values and ethics, internal control, corporate risk management and audit committee functioning are identified as the most significant corporate governance issues facing healthcare administration organisations.
- Information systems and the maximising of process performance to inhibit administration costs are identified as the most pressing operational issues facing medical schemes.
- The individual business functions of statutory, actuarial risk and claims management are identified as the most critical within the healthcare administration organisation.
- The implementation of governing rules and ensuring that medical schemes members interests are protected are identified as the top two functions of the Council of Medical Schemes.
- Top executive commitment and buy-in is considered the most important element of the methodology initiation phase. The need for up to date systems and data to provide timely information was considered to be the most difficult step in implementing within this phase.
- A suitable oversight structure and the need for clearly defined roles and responsibilities are considered very important within the adopted goals, objectives and oversight phase. The most difficult step in implementing within this phase was clearly defined roles and responsibilities.
- Both the need for a defined common language and approved risk tolerances are rated as relatively important. Of these two issues, the implementation of risk tolerances is considered the most difficult. All respondents had progressed poorly in implementing the elements of common language and risk tolerance levels.
- The use of risk frameworks to assist in ensuring that all potential risks are identified is considered fundamental. Organisations felt they had progressed well in implementing such a framework.
- Approved risk management strategies are considered to be essential in ensuring that trustee and senior management expectations are met when addressing unacceptable levels of risk. Progress in this area was poor.
- Ensuring that the corporate risk management process was actively involved in strategic initiatives was one of the most difficult elements in

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implementing. However, with regard to implementation within their organisations, respondents indicated that this continuous improvement element was the most advanced.

- The utilisation of external risk management experts was the least important of the continuous improvement elements. It appears that healthcare organisations preferred to improve their corporate risk management processes based on own experience and internal demands from senior management and trustees.
- The use of pilot projects as a means of obtaining an early glimpse of how the final corporate risk management process would operate was important and could be implemented within a period of three to six months.

## **11.2 Areas of further research**

Healthcare administration organisations in South Africa have a daunting task ahead of them in terms of addressing increased consumer needs and effectively managing more stringent regulatory controls. Similar concerns exist within the healthcare industry on an international level. Accordingly, it is recommended that further research be performed on how South African corporate risk management initiatives critically compares with similar non-South African organisations.

## **11.3 Conclusion**

External and internal risks threaten the achievement of organisational objectives. If not adequately controlled, these risks may lead to significant adverse consequences that impact the performance of business processes and the performance of the healthcare administration organisation as a whole. Consequently, the significance of these risks should be assessed at all levels of the medical scheme and should be regularly monitored. Significant risks should be sourced to their root causes in order that appropriate risk management strategies be deployed to reduce risk levels below or at accepted tolerance levels.

It is the overall opinion of the author that corporate risk management within the healthcare administration industry will become a cornerstone of effective business management. It will influence the manner in which such organisations of the future are structured and the way in which strategic planning is performed. Not only will it improve corporate governance practices but will allow organisations to become pervasive in addressing new threats and possible areas of opportunity thereby adding value to their stakeholders.

Although respondents to the empirical study have not attained a level where corporate risk management is fully implemented, it is apparent that this is their future ambition.

# Annexures

**ANNEXURE A****CORPORATE RISK MANAGEMENT SURVEY****A. Introduction**

This survey will be applied in identifying the key risks faced by the South African Private Healthcare Administrator and in developing a suitable corporate risk management programme.

**B. Reason for undertaking study**

Based on an evaluation of South African healthcare administration literature relating to corporate risk management, it would seem that little attention has been given to this field of study. The following specific areas of weakness have been identified:

- Slowness of South African Healthcare Private Administrators in adopting corporate risk management.
- Increased regulatory risks that could be effectively addressed by a corporate risk management programme.
- Slowness of professional bodies in promoting corporate risk management as one of the key processes within business management.
- Lack of industry awareness regarding developments in the field of corporate risk management based on international best practice.

**C. Key Definitions**

The following definitions should be relied upon:

*Risk* - A concept used to express uncertainty around all possible future events, which could significantly influence the achievement of the organisation's collective business objectives.

*Corporate Risk Management* - The structured process of identification, assessment and the continuous management of the combined risks aimed at ensuring stakeholder expectations are achieved.

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**D. Completing the Survey**

The survey is subdivided into 4 sections. The sections cover:

- Fundamental concepts
- Risk identification within the medical scheme environment
- Risk management continuum issues
- Uniform processes

Each of the sections requires the reader to input either one or more of the following:

- Importance score
- Manageability score
- Absolute scores in terms of Severity and Likelihood
- Implementation status score
- Difficulty in implementing score

The scales applied will be referred to at the bottom of each page of the survey.

**E. Overall**

All results will be treated in the strictest confidence and only aggregated results will be presented.

Please do not hesitate to contact the writer on 082 602 0601 should you require any additional information or experience difficulty in completing the questionnaire.

<b><i>Name of person completing questionnaire</i></b>		
<b><i>Designation</i></b>		
<b><i>Organisation</i></b>		
<b><i>I would like a copy of the end results</i></b>	<b>Yes</b>	<b>No</b>
<b><i>Mark with an (X)</i></b>		

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**1. Fundamental Concepts****1.1**

Corporate governance:

	<b>Yes</b>	<b>No</b>	<b>Importance</b>
The issue of corporate governance standards, i.e. King, has increased the importance of corporate risk management within your organisation?			

**1.2**

Corporate Governance Priorities - Assign levels of importance to the following criteria relating to governance of the medical scheme and how well you believe this is being managed within your own organisation:

	<b>Importance</b>	<b>Manageability</b>
1. Employment equity/transformation		
2. Succession management		
3. Management performance and effectiveness		
4. Organisational performance measures		
5. Vision and Strategy		
6. Board composition and leadership		
7. Corporate Risk Management		
8. Board accountability, remuneration and performance		
9. Internal control		
10. Values and ethics		
11. Internal and external reporting		
12. Social and community involvement		
13. Worker participation		
14. Policy making and compliance		
15. Environmental issues		
16. Audit committee functioning		
17. Compliance with laws and regulations		
Other?		

**Importance Scale:**

&gt;8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Manageability Scale:**

&gt;8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary

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**1.3**

Which of the following factors are considered to be the most pressing issues facing the medical scheme environment in South Africa and how do you believe this is being addressed within your own organisation?

	<b>Importance</b>	<b>Manageability</b>
1. Effectively manoeuvring an environment facing continuous volatility in terms of legislative requirements		
2. Meeting new financial reporting requirements		
3. More effective actuarial risk management practices to address the impact of terminal diseases on the funds of the more healthy		
4. Increased prevalence and complexity of service capitation contracts (i.e. per diem rates)		
5. Addressing and preventing fraudulent activities both internally and externally		
6. Maximising operational performance to ensure administration costs remain reasonable to the medical scheme		
7. Implementing or improving a cost effective healthcare option for the lower income population		
8. Implementing suitable combat mechanisms to address the effects of medical inflation		
9. Implementing or maintaining effective information systems to meet the demand of increased information requirements by management		
Other?		

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Manageability Scale:**

>8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary



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**1.4**

Which of the following factors regarding corporate risk management within the duties of the administrator are cause for concern and how well do you believe they are being managed within your organisation?

	<b>Importance</b>	<b>Manageability</b>
1. Current risk management systems are unable to identify and manage all potentially significant risks in time or in advance		
2. The responsibilities for risk management have not been defined within the context of the administrator and medical scheme		
3. Certain risk types are currently being addressed better than others		
4. Risk management is focused on the negative side of risk and does not consider risk as areas of possible opportunity		
5. Risk management does not address the requirements of the updated King Report on Corporate Governance and other authoritative standards		
6. Risk management is not focused on ensuring that members interests are maximised		
7. Risk Management is treated as an afterthought		
8. The need for improved corporate risk management considering the increase in public awareness regarding risk management		
9. Techniques used to quantify risk are outdated and subjective		
Other?		

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Manageability Scale:**

>8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary

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**1.5**

Which of the following functions of the council of medical schemes do you consider important?

	<b><i>Importance</i></b>
1. Protect the interests of members at all times	
2. Control and coordinate the functioning of medical schemes in a manner that is complementary with the national health policy	
3. Make recommendations to the Minister of Health on criteria for the measurement of quality and outcome of the relevant health services provided for by the medical schemes and such other services as the Council may determine, from time to time	
4. Investigate complaints and settle disputes in relation to the affairs of medical schemes as provided for in the Act	
5. Collect and disseminate information regarding private healthcare	
6. Make rules, not inconsistent with the provisions of the Act, for the purpose of the performance of its functions and the exercise of the Council's powers	
7. Advise the Minister of Health on any matter concerning medical schemes	
8. Perform any other functions conferred on the Council by the Minister or by the Act	
Other?	

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***Importance Scale:***

>8 = Crucial.....7.....6= important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

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**1.6**

What improved benefits do you believe a corporate risk management programme could bring to administration of the medical scheme and how well do you believe they are being addressed within your own organisation?

	<i>Importance</i>	<i>Manageability</i>
1. Management has comprehensive and accurate information at hand to formulate informed decisions regarding the trade-off between risk and reward in advance		
2. Medical scheme objectives are maximised by ensuring that new strategic concepts are fully assessed before being executed		
3. All business resources are aligned with the purpose of evaluating and managing the uncertainties the medical scheme faces as it creates value		
4. Selects and implements the best strategy for exploiting desirable risks while concurrently mitigating or eliminating undesirable ones		
5. Allows better allocation of capital to risk driven initiatives		
6. Provides certain protection against executive liability and adverse publicity or attention from investor and other stakeholders		
7. Optimises the integration of all risk management and assurance activities (e.g. internal audit; quality assurance, fraud, etc.) thereby avoiding duplication of effort		
Other?		

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Manageability Scale:**

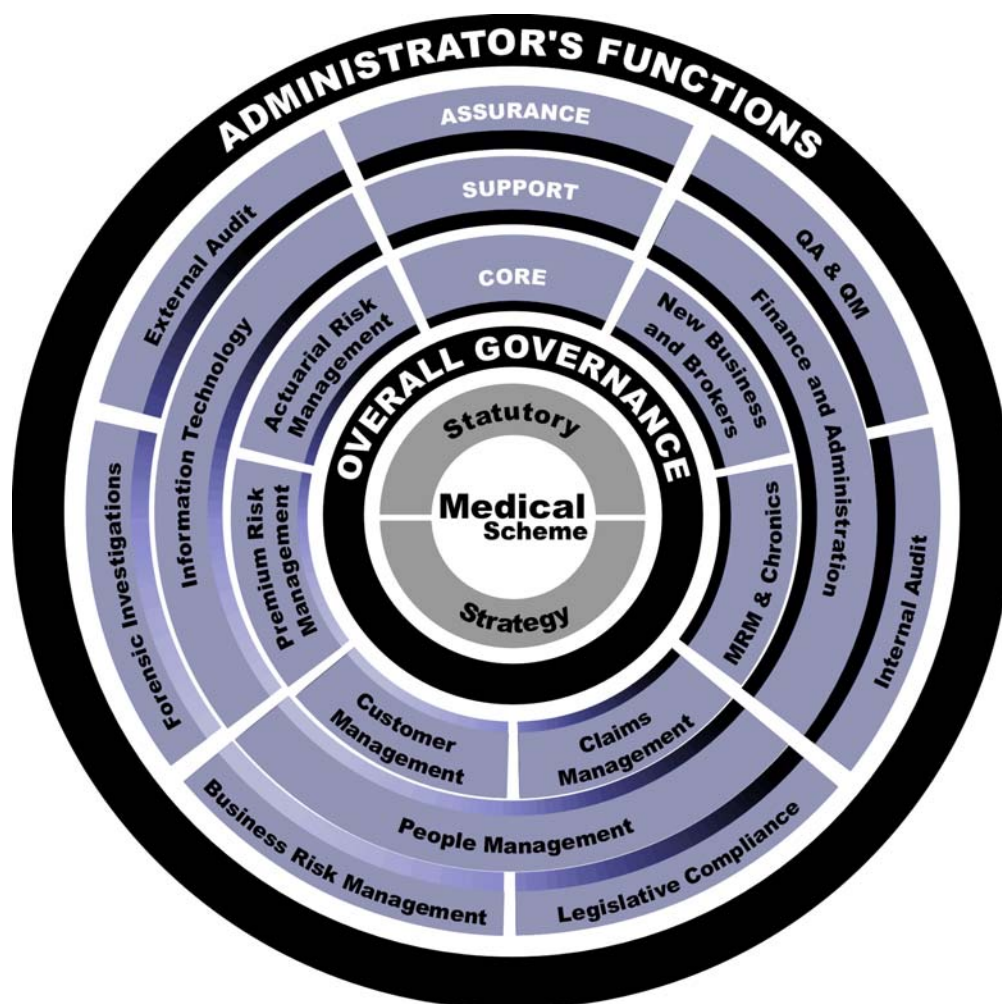
>8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary

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## 2. Risk Identification

The key processes/business units, which support the medical scheme's operations, *could be* depicted as follows:




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**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

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## 2.1

Please indicate the areas that are within your environment and include any additional, which are not referred to.

Space is also provided in the table for an weight rating. This rating refers to how critical you consider this business unit/function within your environment:

		Key roles	Applicable?		Importance
			Yes	No	
Governance	Strategy	Research and development			
	Statutory	Trustee responsibilities			
	Other?				
Core	Actuarial Risk Management	Forecasting and actuarial functions			
	Premium risk management	Collection of premiums and debtor management			
	Customer management	Call centre and customer relationship initiatives			
	Claims management	Claims payments and assessing			
	Medical risk management and chronic benefits	Pre-authorisation of hospital intake and chronic medication applications			
	New business and brokers	New member take-on and broker management			
	Other?				

Continued...

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

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		Key roles	Applicable?		Importance
			Yes	No	
<i>Support</i>	Finance and administration	Regular financial reporting and reconciliations			
	People management/ HR	Staff utilisation optimisation and succession planning			
	Information technology	Key support systems and systems development			
	Other?				
<i>Assurance</i>	Quality assurance or management	Daily monitoring and feedback of key transaction processes, e.g. ISO9000			
	Internal audit	Objective assessment of risks			
	Legislative compliance	Compliance with the Medical Schemes Act and regulations			
	Risk management	Proactive risk management assistance and coaching			
	Forensic investigations	Fraud detection and prevention			
	External Audit	Statutory reporting and ad hoc assignments, e.g. GAAP			
	Other?				

**Importance Scale:**

&gt;8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

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**2.2**

The section below provides details on possible risks that could be encountered within each of the areas identified above.

Each risk should be assessed based upon two criteria, viz. severity and likelihood. It is important to note that these scores should exclude current controls in place within your organisation (i.e. absolute risk). The following definitions of severity and likelihood apply:

*Severity* - The financial loss and sustainability of key operations in the event of the risk being realised.

*Likelihood* - The likelihood of the risk occurring assuming *no control in place*.

Example:

<b>Area</b>	<b>Risk</b>	<b>Severity</b>	<b>Likelihood</b>
<b>Information Technology</b>	Failure to continue business activities in case of a disaster, as a result of a lack of a disaster recovery plan.	5	1

**Severity Scale:**

5 = Catastrophic.....4 = Major.....3 = Moderate.....2 = Minor.....1 = Insignificant.....0 = N/A

**Likelihood Scale:**

5 = Almost certain.....4 = Likely.....3 = Moderate.....2 = Unlikely.....1 = Rare

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Area	Risk	Severity	Likelihood
<b>Governance And Statutory</b>	Senior management have not taken responsibility in developing long to short-range business plans that will allow the medical scheme's mission and goals to be achieved.		
	Control mechanisms to ensure compliance with governing legislation are not in place.		
	The scheme does not address existing corporate governance standards and other oversight body recommendations.		
	Management has not established its own systematic risk assessment framework that is applied on a consistent basis.		
	Unauthorised/authorised personnel have access to financial/medical information.		
<b>Actuarial Management</b>	<p>The following 5 criteria are not considered in actuarial based calculations:</p> <ul style="list-style-type: none"> <li>• <i>Asset risk</i> The risk of adverse fluctuations in the value of assets.</li> <li>• <i>Underwriting risk</i> The risk that premiums will not be sufficient to pay for services or claims.</li> <li>• <i>Credit risk</i> The risk that providers and plan intermediaries paid through reimbursement methods that require them to accept utilisation risk will not be able to provide the services contracted for and the risk associated with recoverability of the amounts due from reinsurers.</li> <li>• <i>Business risk</i> The general risk of conducting business, including the risk that actual expenses will exceed amounts budgeted.</li> <li>• <i>Economic risk</i> The risk that is inherent to the South African economy for e.g. the Dollar/Rand exchange rate fluctuations and interest rate fluctuations.</li> </ul>		

Continued...

**Severity Scale:**

5 = Catastrophic.....4 = Major.....3 = Moderate.....2 = Minor.....1 = Insignificant.....0 = N/A

**Likelihood Scale:**

5 = Almost certain.....4 = Likely.....3 = Moderate.....2 = Unlikely.....1 = Rare



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<b>Area</b>	<b>Risk</b>	<b>Severity</b>	<b>Likelihood</b>
<b>Premium Management</b>	Incorrect premiums charged to members.		
	Premiums received are not correctly allocated resulting in: <ul style="list-style-type: none"> <li>• Members receiving none/inadequate benefits</li> <li>• High incidences of client queries and dissatisfaction.</li> </ul>		
	Outstanding debtors are not properly managed, in terms of: <ul style="list-style-type: none"> <li>• Ageing of debtors</li> <li>• Reconciliation's</li> <li>• Follow-up of debtors and tracing accounts.</li> </ul>		
	Member withdrawal debt (clawback) is not pro-actively managed and followed-up resulting in high cost to the scheme in terms of debt collection and legal costs.		
	Incorrect or unauthorised premium refunds resulting in loss of income for the scheme.		
	Lapses and suspensions are not followed-up timeously resulting in losses for the scheme.		
<b>Customer Management</b>	Non-achievement of service level agreements and customer expectations, in terms of: <ul style="list-style-type: none"> <li>• Call centre management</li> <li>• Provider relations</li> <li>• Marketing initiatives</li> <li>• Public relations and reputation management.</li> </ul>		
<b>Claims Management</b>	Performance in terms of key claims operations are inadequate.		
	Inadequate system input standards are not in place.		
	Lack of controls with regard to collection and insufficient tracking procedures of claims.		
<b>Medical Risk Management</b>	Incorrect pre-authorisation procedures when loading in-hospital events.		
	Lack of concurrent and retrospective case management.		
	Insufficient bill audit review process.		
	Lack of understanding and application of preferred provider arrangements.		

Continued...

**Severity Scale:**

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**Likelihood Scale:**

5 = Almost certain.....4 = Likely.....3 = Moderate.....2 = Unlikely.....1 = Rare

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<b>Area</b>	<b>Risk</b>	<b>Severity</b>	<b>Likelihood</b>
<b>Chronic Benefits</b>	Members exceed their benefit allowances.		
	Suitable monitoring controls are not in place to assess the member's needs for Chronic medication on a regular basis.		
	Suitable checks are not conducted to ensure that medicines applied for are not in contradiction with one another.		
	Not all Chronics applications loaded are supported by an authorised application form.		
	Little/no controls in place to effectively monitor the decisions made by pharmacists.		
<b>New Business &amp; Brokers</b>	New Business applications are not distributed to all outbound activities and services timeously.		
	Underwriting of new members not compliant with medical aid rules.		
	Premiums quoted disagree to actual premiums charged.		
	Performance in terms of key broker commissions operations is inadequate.		
	No accreditation process for brokers.		
<b>Information Technology</b>	The existing system development methodology does not address all key control areas expected within a systems development environment.		
	The non-measurement and ongoing monitoring of system capacity resulting in key applications being unavailable.		
	Uncontrolled logical access to systems may result in unauthorised admittance to confidential data.		
	Loss of productivity due to user problems not being addressed timeously.		
	Uncontrolled access to the high risk IT premises may result in damage to company resources.		
	Failure to continue business activities in case of a disaster, as a result of a lack of a disaster recovery plan.		
<b>People Management</b>	Sufficient human resources are not in place to achieve business objectives.		
	Appropriate orientation and ongoing training is not provided to set/maintain the knowledge and skills of all personnel.		

Continued...

**Severity Scale:**

5 = Catastrophic.....4 = Major.....3 = Moderate.....2 = Minor.....1 = Insignificant.....0 = N/A

**Likelihood Scale:**

5 = Almost certain.....4 = Likely.....3 = Moderate.....2 = Unlikely.....1 = Rare

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<b>Area</b>	<b>Risk</b>	<b>Severity</b>	<b>Likelihood</b>
<b>Finance and Administration</b>	The finance department does not reconcile or follow-up outstanding items on reconciliations between all systems and the general ledger on a frequent basis.		
	Adjusting journals and journal descriptions are not controlled and the necessary authorisation is not obtained.		
	No formal budgeting system in place and/or monitoring of expenses.		
<b>Assurance Services</b>	Assurance services do not address existing corporate governance standards and other oversight body recommendations.		
	No formalised process in place to provide formal recommendations to management on weaknesses identified.		
	No formalised process in place whereby follow-up occurs on reported items to management.		
	Assurance services have not established their own systematic risk assessment framework that is applied on a consistent basis.		
<b>Other?</b>			

**Comments:**

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**Severity Scale:**

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### 3. Risk Management Continuum

#### 3.1

Under each of the areas of risk management and risk management and corporate risk management in the table below are certain factors that are characteristic of each of these stages. Use the progress scale of 1 to 10 at the bottom of the table to indicate where you believe your organisation stands on the risk management continuum.

	Awareness		Risk Management				Corporate Risk Management			
	→									
<i>Focus</i>	Financial risk		Financial and internal controls		Risk		Risk			
<i>Benefits</i>	Risk awareness		<ol style="list-style-type: none"> <li>1. Improved business knowledge</li> <li>2. Uncertainties evaluated</li> <li>3. Risk-reward decisions receive more attention</li> <li>4. More effective risk-based decision making</li> </ol>		<ol style="list-style-type: none"> <li>1. Risk anticipated better than competitors</li> <li>2. Linkage between risk management and line operations management</li> <li>3. Improved capital and resource allocation</li> <li>4. Risk transparency with stakeholders</li> </ol>		<ol style="list-style-type: none"> <li>1. Capitalise on market opportunities</li> <li>2. Risk managed as integral part of business management</li> <li>3. Risks aggregated to reduce risk transfer costs</li> <li>4. Risk management integrated with business planning strategy</li> </ol>			
<i>Capabilities</i>			Risk Identification		<ol style="list-style-type: none"> <li>1. Common Risk language adopted</li> <li>2. Dedicated risk management resources</li> <li>3. Risk management policy</li> <li>4. Risk drivers identified</li> </ol>		<ol style="list-style-type: none"> <li>1. Uniform risk management process</li> <li>2. Roles and responsibilities defined</li> <li>3. Risk management policy followed by all</li> <li>4. Risk measurement</li> <li>5. Consistent risk reporting</li> <li>6. Risk management tolerances initiated</li> </ol>		<ol style="list-style-type: none"> <li>1. Enterprise wide task strategies</li> <li>2. More objective risk measurement</li> <li>3. Integrated risk management systems</li> <li>4. Risk measures integrated with business performance and incentives</li> <li>5. Continuous feedback</li> </ol>	
<i>Progress</i>	1	2			3	4	5	6	7	8
<i>Mark here (X)</i>										
<i>Comments?</i>										

#### 4. Uniform Process

##### 4.1

The table below details the steps usually followed in a generic corporate risk management process (stages 1 to 6). Please include the relevant scores in each of the columns below for your respective organisation:

<i>Stage</i>	<i>Sub section</i>	<i>Importance</i>	<i>Implementation status</i>	<i>Difficulty in implementing</i>
<b>1. Implementation feasibility</b>	Top executive commitment and priority.			
	Sufficient buy-in from all other levels of management.			
	The environment is one of open sharing and regular feedback and escalation.			
	Systems and data are in place to provide timely information to management.			
<b>2. Adopt goals, objectives and oversight</b>	A risk management vision or policy is established and communicated to the entire administration company.			
	An organisational oversight structure is implemented such as a risk management committee.			
	Clearly defined roles and responsibilities for identification, management and reporting of risk.			
<b>3. Adopt common language</b>	Common language for standard terminology is implemented, e.g. common definition of risk in place.			
	Risk tolerances indicating acceptable levels of risk for the administrator and scheme trustees have been determined.			

Continued...

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Implementation 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

<b>Stage</b>	<b>Sub section</b>	<b>Importance</b>	<b>Implementation status</b>	<b>Difficulty in implementing</b>
<b>3. Adopt common language</b>	A risk framework exists that identifies broad risk types, which are relied upon when conducting routine assessment within operations (e.g. a risk template).			
<b>4. Establish risk management strategies</b>	Approved risk management strategies have been determined and sanctioned by the administrator and trustees, e.g. Avoid, Retain, Reduce Transfer, and Exploit.			
	Trustees in conjunction with senior management have defined acceptable levels of risk that are measured against when routine assessments are conducted.			
<b>5. Adopt uniform process</b>	A consistent uniform process for identifying and managing existing risks is in place and has been suitably communicated.			
<b>6. Continuous improvement and lessons learnt</b>	Consolidated reporting for trustees and board members is in place that provides feedback on highrisk areas.			
	Communication and training, e.g. communication of risk management guidelines to trustees, senior management and operations.			
	Embedding risk management into existing processes and activities and the implementation of self-assessment systems.			
	Integration of other assurance and risk management activities across the organisation, e.g. internal audit, rely on risk management assessments.			

Continued...

**Importance Scale:**

&gt;8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Implementation Status:**

&gt;8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary

**Difficulty in Implementing:**

&gt;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

Stage	Sub section	Importance	Implementation status	Difficulty in implementing
<b>6. Continuous improvement and lessons learnt (Continued)</b>	To ensure success a Pilot of the implementation process has been conducted of areas and lessons learnt, derived from the pilot session.			
	Utilising internal benchmarking practices in cases where processes are repeated within the administration function across various geographical locations.			
	Design of mechanisms for sharing information on risks, viz. lessons learnt.			
	Utilising risk management experts to assist in ensuring that the current risk management methodologies comply with best practice, e.g. 'big five' consultants.			
	Corporate risk management proactively involved in new projects and new strategy initiatives.			
	Employee yearly appraisals consider risk management criteria when awarding salary increases and promotions.			
	Consolidated reporting of the schemes key risks exists and is relied upon by the trustees and management at regular intervals, e.g. use of risk management software such as CURA, Risk Advisor, etc.			

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Implementation 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

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**4.2**

In quantifying the extent of risk, the following types of techniques are usually noted:

<b><u>Degree of Sophistication</u></b>	<b><u>Risk Quantification Technique</u></b>
<b>High</b>	Statistical analysis e.g. Value at Risk (VaR), Montecarlo Simulation
	Scenario planning
	Delphi method
<b>Moderate</b>	Exposure and volumetric measurement
	Risk Mapping
	Risk indicator analysis
<b>Low</b>	Group Facilitated qualitative prioritisation
	Individual qualitative self-assessment

Please indicate below whether these are being applied in your organisation, and if so, their associated importance and implementation status:

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***Importance Scale:***

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

***Implementation Status:***

>8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary



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	<i>Applicable</i>		<i>Importance</i>	<i>Implementation status</i>
	<i>Yes</i>	<i>No</i>		
Individual Qualitative self-assessment				
Group facilitated qualitative prioritisation				
Risk indicator analysis <sup>1</sup>				
Risk mapping <sup>2</sup>				
Exposure and volumetric measurement <sup>3</sup>				
Delphi method <sup>4</sup>				
Scenario planning <sup>5</sup>				
Statistical analysis, e.g. value at risk, etc.				
Other?				

<sup>1</sup> This technique utilises decision aids to help users identify and evaluate qualitative risk factors. Decision aids typically provide a summary of questions that depending on the response, suggest possible symptoms or “red-flags”.

<sup>2</sup> Assessment of risk based on likelihood and severity.

<sup>3</sup> What is the cost or benefit of the risk after all likely risk transfer strategies and opportunity exploitations have been considered.

<sup>4</sup> Appointment of a panel of experts to consider possible risks and associated measures. The subsequent coordination of results to prepare a composite list that is then returned to the experts for comparison with their initial lists.

<sup>5</sup> Management utilises scenarios to discuss their current plans, examine current results against possible futures and explore the risks and opportunities that may occur.

**Importance Scale:**

>8 = Crucial.....7.....6 = important.....5.....4.....3 = cognisant.....2.....1 = unnecessary.....0 = N/A

**Implementation Status:**

>8 = Managed/optimised.....7.....6 = defined.....5.....4.....3 = repeatable.....2.....1 = initial/rudimentary

## ANNEXURE B

### SAMPLE CORPORATE RISK MANAGEMENT POLICY<sup>6</sup>

It is the policy of this healthcare administrator to adopt a common approach to the management of risk. This approach involves a clearly stipulated strategy defining the risks that the administrator is in business to take and those that it is not.

Our approach is as follows: Corporate risk management is the structured process of identification, assessment and continuous managing of the combined risks that affect our values.

The foundation of this policy is the obligation and desire to protect:

- Our members;
- The environment in which we operate; and
- Our position as provider of the highest quality services.

Our policy in respect of these foundation attributes is that physical, financial and human resources will be applied to ensure our standards of product achieve and exceed expectations – no other priority will be more important.

It is also our policy that to achieve the economic expectations of our stakeholders, the organisation must pursue opportunities involving a certain degree of risk. Our policy is to give full and due consideration to the balance of risk and reward, as far as practicable, to optimise the rewards gained from our business activities.

The application of this policy will be the responsibility of the Board through the Chief Executive Officer. The Chief Executive Officer and Executive

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<sup>6</sup> Adapted from source: DeLoach, 2000

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Management team is responsible for the implementation of this policy through a risk management programme. Reporting of performance against policy and strategic targets will be conducted routinely depending on the nature of the risks.

This strategy is supported by analytical techniques to identify and evaluate risk, control and response measures to improve/optimize the scheme's risk profile and key performance indicators and communication techniques that apply across and upwards through the organisation. This policy and underlying strategies will be reviewed annually by the Board of Trustees to ensure its continued application and relevance. An independent review of the adoption and effectiveness of this policy will be undertaken prior to the Board's review on a semi-annual basis.

The organisation is committed to the philosophy of effective business risk management as a core managerial capability.

Signed and dated:

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**Chief Executive Officer**

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**On behalf of Trustees**

## ANNEXURE C

### SAMPLE RISK MANAGEMENT COMMITTEE CHARTER

The Board should make use of generally recognised risk management frameworks in order to maintain a sound system of risk management. Recognised risk management initiatives include the following three scopes of work:

1. Safeguard the company's assets and investments.
2. Support business objectives and sustainability under normal as well as under adverse operating conditions.
3. Behave responsibly towards all stakeholders having a legitimate interest in the organisation.

The quality, integrity and reliability of the organisation's risk management are delegated to the risk management committee ("Committee") by the Board.

## **Mission Statement**

The Committee's key responsibilities will be to provide independent and objective oversight and to review the information presented by management on corporate accountability and associated risks<sup>7</sup>.

## **Authority**

The Committee will:

1. Have access to all information it needs to fulfil its responsibilities.
2. Investigate matters within its mandate.

The Committee, in carrying out its tasks under these terms of reference, may obtain such outside or other independent professional advice, as it considers necessary, in order to carry out its duties. The Board will ensure that the Committee will have access to professional advice both inside and outside of the company in order for it to perform its duties.

These terms of reference may from time to time be amended as required, subject to the approval of the Board.

## **Membership**

The Committee shall be chaired by the CEO with full participation of the Senior Executive Committee.

The Company Secretary shall be responsible for minute taking and overall meeting administration.

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<sup>7</sup> Refer page 246

### ***Interaction with Audit Committee***

The Audit Committee is a separate forum governed by its own charter that has been sanctioned by the Board.

The overall function of the Audit Committee is to ensure that management has created and maintained an effective control environment and demonstrates and stimulates the necessary respect for the internal control structure amongst all parties.

### ***Responsibilities***

The Committee will:

1. Review and assess the integrity of the risk control systems and ensure that the risk policies and strategies are effectively managed.
2. Set out the nature, role, responsibility and authority of the risk management function within the company and outline the scope of risk management work.
3. Monitor external developments relating to the practice of corporate accountability and the reporting of specifically associated risk, including emerging and prospective impacts.
4. Together with the company's legal advisor any legal matters that could have a significant impact on the company's business.
5. Review the Executive Committee's reports detailing the adequacy and overall effectiveness of the company's risk management function.
6. Ensure compliance with such policies, and with the overall risk profile of the company.
7. Review the adequacy of insurance coverage.
8. Review risk identification and measurement methodologies.
9. Monitor procedures to deal with and review the disclosure of information to clients.
10. Have due regard to the principles of governance and codes of best practice.
11. Liaise with the board in relation to the preparation of the Committee's report to shareholders as required.

### ***Meetings***

Meetings of the Committee will be held, as the Committee deems appropriate, however, the Committee should meet at least twice a year. Meetings should be organised so that attendance is maximised.

The Chairperson of the Committee or any member of the Committee may call a meeting at any other time. The Chairperson, in their discretion, may invite such executives and senior management as appropriate to attend and be heard at meetings of the Committee. In addition, the Finance Director, Chief Executive Officer and executives specifically responsible for risk in the company, including the head of internal audit, shall attend meetings of the Committee but shall not have a vote.

### ***Proceedings***

The following will apply:

1. The company's articles of association will govern meetings and proceedings of the Committee.
2. The Committee secretary shall take minutes of meetings.
3. Minutes of all meetings shall be circulated to all the members of the Committee and shall be included in the board papers for the next meeting. The minutes will also be forwarded to the Chairperson of all other board committees.



**Risk**

Risk in the widest sense includes market; credit, liquidity, operation and commercial risk that cover detailed combined risks such as:

1. Interest rate risk;
2. country risk;
3. fraud risk;
4. quality risk;
5. counterpart risk, including provisioning risks;
6. currency and foreign exchange risk;
7. technology risk;
8. price risk;
9. disaster recovery risk;
10. operational risk;
11. prudential risk;
12. reputation risk;
13. competitive risk;
14. legal risk;
15. compliance and control risks;
16. sensitivity risks e.g. environmental, health and safety;
17. concentration of risks across a number of portfolio dimensions;
18. investment risk;
19. asset valuation risk; and
20. others appropriate to the business that may be identified from time to time.

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