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Introduction to ERM for Health Insurers


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The 30,000 Foot View




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What is ERM?

- "ERM is the discipline by which an organization in *any industry* assesses, controls, *exploits*, finances and monitors risks from *all* sources for the purpose of increasing the organization's short- and long-term value to its stakeholders."

Source: CAS Committee on Enterprise Risk Management, May 2003 report; (KLC italics)



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ERM's Value Proposition

- Risk opportunities
- Robust risk intelligence information
- Alignment of incentives
- Cost reduction
- Better coordination

Source: *Risk Management* (newsletter of the Risk Management Section), March 2004



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ERM: The Movement

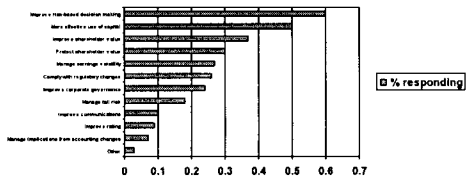
- Turnbull Initiative of 1999 (UK)
- Basel II Accord
- Sarbanes Oxley
- COSO framework
- Rating agencies
- Public demand for transparency



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The ERM Movement

Key Objectives for Improving Risk Management



Source: Tillinghast Towers-Perrin, 2004 Benchmarking Survey Report




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ERM: The Movement: What's Changed?

- More risks?
- More risk awareness?
- More visible corporate failures?
- More ways to manage risks?
- More pressure on economic performance?
- More regulation?

Slide credit: David Ingram




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The ERM Challenge


- "Return on Investment"
- What to measure
 - Avoided outcomes
 - Opportunity costs
- How to measure
 - The metrics
 - The "connections"



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Taking a Closer Look



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Definition of Risk

- Risk is the product of two essential ingredients
 - Uncertainty (likelihood and magnitude)
 - Preferences
- Whose preferences?



The ERM Framework

- An action-oriented process
- Three major steps
 - Risk identification
 - Risk measurement
 - Risk management



Risk Identification


- Identify all key exposures
 - Easy to ignore “unlikely” risks
 - Easy to miss sources of risk
 - Risk is dynamic, new exposures are being created constantly
 - Requires a disciplined process
 - Depends on good information flow



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Risk Measurement


- Identify the range of outcomes
- Determine the likelihood of different outcomes
- Establish the relationship between the drivers of the “outcome” process and the outcomes
 - If the drivers change, how will the outcomes change?

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Risk Measurement


- Risk measurement can be difficult
 - Lack of data
 - Tail probabilities
 - Ever-changing environment
 - Art as well as science
 - Correlations are important

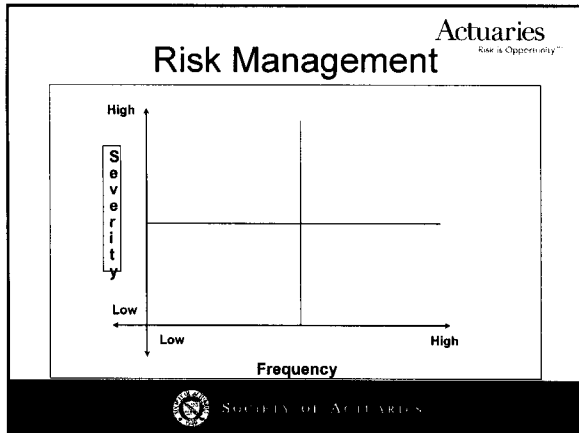
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Risk Management

- “Management” requires objective-setting and action plans/tactics
 - Establish risk-tolerance levels (earnings volatility, extreme outcomes, etc.)
 - Protection of key resources
 - Satisfying external monitors

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- ## Recent Developments
- Recognition that RM is a process
 - Recognition that RM process needs to be "managed"
 - Management of RM process requires leadership and communication skills, rather than technical skills in quantifying risks
 - Business acumen to understand the sources of risk for the enterprise, both external (environment) and internal (business processes)
 - CRO infrastructure
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- ## Recent Developments
- Emerging idea that an ERM process could add value to a wide range of organizations
 - There's more to risk than buying insurance
 - Existence of a good RM process itself can enhance value by reducing risk to shareholders and improving transparency
 - "The right thing to do" in light of financial scandals
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Recent Developments

- Systematic approaches to identifying risks
 - Market (external factors affecting entire economy and specific industry)
 - Credit/underwriting (selection/monitoring of contracting counterparties)
 - Operational (process quality and control)



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Recent Developments

- Paradigms applicable to industry categories based on key types of risk exposures
 - Financial services, energy, insurance
- Growing body of research
 - Increasing interest within academic community
 - Growing number of researchers at distinguished universities entering this field of research
 - Finance, Econometrics, Statistics etc.
- Successful application of new techniques



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Recent Developments

- Expanding level of integration
 - From product/local level to enterprise/conglomerate level
 - Growing interest in understanding covariances and relationships across product lines and areas of a company
 - Sources of common and unique risks
 - Differential impact of risk sources



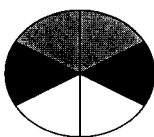
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Health Insurer Risks



- Environmental Risk
- Financial Risk
- Operational Risk
- Pricing Risk
- Reputation Risk
- Strategic Risk



The Framework

- Risk Identification
- Risk Measurement
- Risk Management



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Category Alignment

- General
- Market
- Credit/UW
- Operational

- Health
- Environmental
- Financial
- Pricing
- Operational
- Reputation
- Strategic

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Environmental Risk

- Buyer environment
- Competition
- Economy
- Fraud (external)
- Legal
- Regulatory/legislative
- Supplier environment

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Financial Risk


- Asset default
- Data
- Financial viability
- Interest rate
- Liquidity
- Model risk
- Reinvestment risk
- Reserve adequacy


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Operational Risk

- Billing and collections
- Claims processing
- Contract wording
- Data technology and management
- Fraud (internal)
- Human resources
- Network management
- Reinsurance
- Sales Force
- Training
- Vendor relations

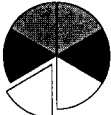



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Pricing Risk

- Anti-selection
- Authority
- Competition
- Data
- Financial viability of capitated providers
- Model
- Mortality
- Regulatory/legislative
- Reinsurance
- Trend (inflation, intensity, technology, utilization)
- Underwriting





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Reputation Risk

- External
 - Disgruntled policyholder
 - Rating agencies
 - Stock analysts
- Internal
 - Claims adjudication
 - Corporate governance
 - Distribution
 - Fraud





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Strategic Risk

- Capital management
- Growth
- Incentives
- Management failure
- Mergers and acquisitions
- Network management
- Reinsurance




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Health Risks

A Hypothetical Case for Review

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Q&O

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