Enterprise Risk Management (ERM): A New Reality for Business
By Dan Cassidy, FSA

Editor's note: This column is one of a series and is reprinted from the May 2005 issue of Aspen Publishers' Employee Benefit Plan Review. *We hope to present further articles from this series in future issues of* The Independent Consultant.

"The cost of healthcare in the US is making American businesses extremely uncompetitive versus our global counterparts." So stated Rick Wagoner, CEO of General Motors in a speech to the Economic Club of Chicago on February 10, 2005. When the CEO of the largest manufacturer in the United States (and arguably the world) says that healthcare costs are making his firm uncompetitive, we have entered a new reality in the management of benefit plans. Now benefits, whether medical or retirement, can no longer be considered merely a detail within the income statement's "selling, general and administrative expenses" line item.

If medical costs add $1,500 to the cost of each car GM sells, as Mr. Wagoner also said, benefits managers must look beyond the simple cost of benefits to the overall impact they are having (wreaking?) on the entire enterprise. In fact, a whole new field of finance has developed to help managers meet this challenge. It's called enterprise risk management (ERM).

<u>Background</u>

Definition
ERM is the process of planning, organizing, leading and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings. Enterprise risk management also expands the process to embrace not just risks associated with accidental losses but also financial, strategic, operational and other risks.

Traditionally, ERM techniques were used by financial services firms such as banks, insurance companies, etc., who have needed to "match" their liabilities (insurance policies) with their underlying assets (reserves). ERM has developed further to include managing all areas of risk, both on- and off-balance sheet, and is now used by firms in all industries. ERM goes beyond normal accounting rules for writing down the assets and liabilities of a firm, working further to place a value both on the true market value of an item as well as on the risk associated with that item. The old business adage, "You can't manage what you don't measure" could be considered a central tenet of ERM. By providing more worthwhile information about risk, managers (and for that matter – shareholders) can make more informed decisions.

Example
An example may help to understand how ERM techniques could be applied to a defined benefit ("DB") retirement plan. Briefly, defined benefit plans are retirement plans in which the employer promises a fixed level of benefits to participants when they retire. These benefits are paid out of a trust fund that the employer sets up and funds. Typically,

the employer is 100 percent responsible for any contributions into a DB plan trust and current accounting rules require only expensing these plans in the income statement. However, the actual surplus or deficit of the trust fund is "off-balance sheet" – simply contained in a footnote disclosure that has little, if any, impact on the actual net worth of the company.

ERM, on the other hand, would view a pension plan as a *de facto* insurance company. In GM's case, for example, its current market capitalization is $19 billion while its retirement plans in the United States alone total assets of $80+ billion as of the end of 2003. So in the case of GM, the question becomes, when you buy GM stock, are you buying a car company that happens to have a retirement plan, or are you buying an insurance company that just happens to make cars?

The following illustration compares how ERM would differ from the current accounting standards in how pension plans should be reflected on the books of the company.

	Current Accounting (FASB) Viewpoint	**Enterprise Risk Management Viewpoint**
Income Statement	Includes annual expense measured with various smoothing techniques to allow for predictability	Includes annual expense using no smoothing techniques, i.e., actual return on assets NOT expected return
Balance Sheet	Includes only a single measure that balances out past expense values with past contribution amounts	• Includes the net market value of (assets – liabilities) in the company's balance sheet. If less assets than liabilities, the value of the firm would be reduced • Includes an adjustment to reflect the possible mismatch of assets and liabilities. If heavily invested in equities, the company would be required to record a reserve to cover possible losses

<u>Risk – What is it?</u>

Central to our examination in these columns of ERM's views on benefit plans will be a running discussion of risk. Traditionally, ERM focused solely on financial risk, i.e., mismatching of assets and liability. But moving beyond this limited definition to a more comprehensive definition suggests risk to include the possibility of facing ANY loss, whether directly measured, such as the traditional mismatching of assets and liability, or an indirect loss like rising health care costs, which in turn impact overall pay and compensation levels. Since human assets are off balance sheet, the true risk faced by organizations is not simply what the accounts add up to. One must also look further down the road toward the longer term implications of changes.

What questions should you ask as you examine your own plans? Try these:
• What are the risks your employees and employers face?
• Who is bearing those risks?
• Who is getting rewarded and who is getting punished?
• What impact is government regulation having on these risk questions?
• What is the long term impact of any shifting of risk likely to produce? Are there any unintended consequences that should be considered?

Principles of Risk Management

When working through these questions, it's important to remember two principles of risk:

1. Whoever bears the risk should be compensated for this risk.
Since the passage of FAS 106, requiring the expensing of retiree medical programs during an employee's work life, many employers have shut down their retiree medical programs. When these plans were shut down, the risk faced by employees for their medical care during their retirement was shifted from employers to employees. In most cases, employers simply shut these plans down with no changes to any other compensation; that is, employers did not give out any pay raises to compensate for this benefit reduction. However, employees will eventually demand higher pay to compensate for facing this risk but such higher future pay is currently not accounted for when employers make this change. It's another off-balance sheet item.

2. Pooling and spreading risk reduces its costs.
Continuing with the retiree medical example, employers provided a service to employees by allowing them to pool the risk of medical care during retirement. This principle states that the overall cost of risks can be reduced if we pool the risks and spread them among a large group. This is one of the primary reasons that insurance companies can offer competitive insurance policies, e.g., homeowner's insurance. By pooling and spreading risks over an entire population, the lack of a great many very risky events – a house burning down for example— allows insurance companies to charge a very affordable price for homeowners.

So by "unpooling" retiree medical insurance, employers miss an opportunity to support a cost-reducing pooling mechanism. This pushes the risks onto the employee, who should (and increasingly will) demand higher pay, forcing employees to find an alternative solution (an AARP plan, perhaps) at retirement.

Dan Cassidy, FSA, Chair of the Smaller Consulting Firm Section, is President of Argus Consulting Ltd, of Concord Mass. (USA), providing retirement plan consulting services for qualified and non-qualified benefit plans of clients in the United States, United Kingdom and Canada. He can be reached at 978.371.8029, danc@arguscl.com or www.ArgusCL.com