

Week 13 Learning Objectives



- Understand the basics of the insurance industry
- Understand the basics of the pension industry and their obligations

Week 13 Lecture Part 1 - Insurance

This week moves away from the securities markets to cover two subjects that are somewhat unrelated yet very interesting and important to us personally. The first is insurance and the second is pensions. I encourage you to take this chapter to heart as it is probably the only exposure to this important financial product you will get. If you have aging parents, look at long term care insurance or if you have little children, look at the life insurance options. Use this as opportunity to review your personal insurance situation.



You have several options in how you manage risk. You can avoid, retain, transfer, share or reduce your risks. One easy way to look at this is to view frequency of the event occurring with the severity of the results when it does occur.

If the event is high frequency and high severity, avoid.
If the event is high frequency and low severity, reduce.
If the event is low frequency and low severity, retain.
If the event is low frequency and high severity, insure the event. This is the place for insurance.



Another view of insurance is to picture the insurance company's view of things. You can get insurance on just about anything. But in general, to be insurable a risk must be non-catastrophic, an accident, non-intentional, a large exogenous exposure and measurable.



The insurance industry is experiencing unprecedented challenges in the 21st century. The repeal of the Glass Steagal Act in 1999 has allowed new competitors into the marketplace, the Internet has created a powerful additional distribution tool, and the changing economy has affected profitability dramatically. As a result, insurance providers are looking for ways to become more efficient, and add new product lines to enable them to provide comprehensive financial

services to their customers. Personally, I can't see my insurance agent providing me with retirement planning and a series of mutual funds. However having talked with several insurance agents, they have a wonderful trusting relationship with their clients and they seem to feel that they can get them to buy into the package concept.

One of the financial products insurance companies typically offer is the annuity. These instruments are used to defer taxes on investment income during the accumulation phase and provide income during the distribution phase. Of course there are drawbacks, the main one being the additional expenses and fees.



One of the issues that plagues the insurance industry is fraud. Nearly one in four U.S. adults say that overstating the value of claims to insurance companies is acceptable, and more than one in 10 say they approve of submitting insurance claims for items that were not lost or damaged or for treatments that were not provided, according to a survey released by Accenture. Two-thirds of respondents (66 percent) said that people are more likely to commit insurance fraud during an economic downturn than when the economy is strong. About half the respondents (49 percent) said that people commit insurance fraud because they can get away with it.

Week 13 Lecture Part 2 - Pensions

The second part of this week is pensions and retirement. This may be the one area that hits closest to home as most of us look forward to the day we don't have to do anything if we don't want to and most of us have planned, at least a little, toward this goal.



One of the most important issues is the difference between defined benefit plans and defined contribution plans. My parents were in the defined benefit plan era and they had a monthly amount paid to them when they retired based on their last salary. I am in the defined contribution era where I have had employers put money into a retirement fund for me but they have no obligation with regard to the returns or payout. This is a major change within the last few generations. As we have

moved the responsibility for retirement from the company to the individual.

One of the benefits for the company in this is that they don't have to manage a large pension fund. There are quite a few companies that have had large losses in their pensions due to the bear market and are now facing the possibility of having to reduce profits to fund the pension. One reason the shortfalls have been so large is that they are allowed to make



assumptions about the future returns for the pension fund and therefore add to it only the amount called for based on their own assumptions of returns. So many assumed that the market would continue up and underfunded it in past years. Now that those returns aren't materializing they are faced with funding not only those years gone by but at lower assumptions on growth. This double whammy is causing significant fear in some of the companies as they are facing billions of dollars of debt with no sign of relief in sight.



The virtuous circle of the late 1990s -- when rising stock prices boosted pension returns and helped increase corporate profits -- has turned into a vicious circle in which declining pension fund assets reduce the investment income available to corporate profits, putting further downward pressure on stock prices.

It's a big issue for companies: About 90% of S&P 500 companies' pension funds were underfunded at the end of 2002, estimates Credit Suisse First

Boston. That would be the first time in a decade that pension assets dropped below future retirement obligations.

Some companies opt to address the growing gap by propping up their funds now with stock and cash, and taking a large charge against their earnings. But it's the other companies that may cause investor concern: They, in effect, ignore the deficit and bet their pension funds' returns will rebound sharply. By forecasting higher future investment returns, companies lower the current cost of their funds and avoid any additional drag on their earnings. Lowering investment forecasts now would force those companies to undertake costly repairs.

As risky as it might seem in the current market environment, many company executives cite strong past performances of their pension funds to project rosy future returns. Some companies even report pension-related profit when the funds are absorbing losses by averaging investment returns over several years.

Once a year, public companies reveal in SEC filings the difference between their investment assumptions and pension returns in off-balance-sheet calculations contained in the footnotes. Those reports are just now landing in force.



USA Today analyzed last year's filings and found that the 16 major U.S. companies with the highest investment-return assumptions were predicting, on average, that their pension funds would grow 10.6% a year. Instead, the Standard & Poor's 500-stock index fell 23% for its third consecutive annual decline. That tempered the companies' predictions. But not by much. This year the 16, on average, are predicting 9.5% annual growth. That still exceeds the S&P's 9.3% average annual

return the last decade, which included the astounding 220% surge from 1994 to 1999.

For perspective, famed investor Warren Buffett predicts the pension funds of his company Berkshire Hathaway will average 6.5% growth. Merrill Lynch, the No. 1 U.S. brokerage, also targets 6.5%.

The twist is when companies average pension profits over several years to boost their corporate profits in years when the pensions actually fall in value. Several companies -- including Darden, Guidant and Lehman -- did this last year even as their fund assets fell below the minimum required to pay future retirement obligations. This legal but controversial practice lets companies overstate earnings and defer costly pension repairs.

Reports are that \$219 billion cumulative earnings reported by S&P 500 companies in 2001 would have fallen 69% to \$68.7 billion had the companies reflected the actual returns of their pension funds. In 2000, he says earnings would have been 10% lower at \$388 billion.

Not everyone is in denial about their pension funds. The toll of the S&P 500's 46% drop from its peak three years ago has proved too much for several blue-chip companies, prompting them in the fourth quarter to take massive earnings charges and reduce shareholder equity to reconcile over-optimistic assumptions:

- * Ford Motor trimmed shareholder equity, a way of backing out previous earnings, by \$5.4 billion. And Ford said annual pension costs will increase by more than \$200 million a year after it reduced its investment-return assumptions to 8.8% from 9.5%.

- * Eli Lilly reduced shareholder equity by \$2.6 billion and dropped its investment-return estimate to 9.3% from 10.5%.

- * DuPont cut shareholder equity by \$2.5 billion and cut its investment-return peg to 9% from 9.5%.

- * General Motors, which propped up its pension fund with \$5 billion worth of GM Hughes stock just two years ago, injected \$2.6 billion in cash in December, bringing its contribution for 2002 to \$4.8 billion. GM also took a \$1.4 billion after-tax charge in the fourth quarter and lowered its investment-return expectation to 9% from 10%. And it plans to contribute an additional 150 million shares of its Hughes stock to its pension plans.



And when companies don't change optimistic forecasts they are having to explain why to the investment community. Weyerhaeuser Vice President Richard Taggart, for instance, recently told

analysts the paper company would meet its 9.5% projection, down from 11% a year ago, because its investment managers expect to outperform the market by 3 percentage points this year. Can you believe this? Who is this guy and who does he think he is kidding? Because of all these smoothing mechanisms it can be argued that what we really have in some cases are fictitious earnings.

Some industries are facing huge pension liabilities and soaring labor costs, and are aggressively seeking ways to save money. Delta Air Lines recently said it could save \$500 million per year by making the switch to a cash-balance plan. Cash balance plans incorporate a percentage of employee earnings, plus interest. Absent any bonuses, younger workers would tend to benefit more than their older colleagues because they have more time to earn interest. There are more than 800 age discrimination complaints pending before the government over cash-balance conversions. The federal Pension Benefit Guaranty Corp., which insures the pensions of 44 million people, has seen last year's \$8 billion surplus eroded by growing pension fund failures. Between 300 and 700 companies have changed to cash-balance plans and another 300 are waiting for IRS approval to make the conversion. Of course, United got out from under its pension obligations in court due to bankruptcy.

