


## The Way We Were ...

by Joseph J. Launie, Ph.D., CPCU, FACHE

There is a nostalgic old ballad titled "The Way We Were." I suggest you go to I-Tunes, download it and play it as background music as you read this article.

Once upon a time, as all good stories start, the predominant pension plan in both the private and government sectors of the economy was the Defined Benefit plan. Under a Defined Benefit plan, the employee is given a formula that determines a pension benefit which the employer guarantees will be paid. Common provisions included plans in which the amount of the pension was based on the average compensation in the last three years of employment. Once the base amount was determined, the pension was determined by a formula, such as 2 percent of the base amount for every year of service.

The Defined Benefit pension plan has many advantages for the employee. The dollar amount of the pension can be calculated by the employee with a fair degree of accuracy a number of years before retirement. This provides employees with a feeling of security which enhances their ability to plan, save and consume. The pension funds are invested by the employer, who bears the market risk. As long as the employer remains solvent, the employee is virtually risk-free. This provides a powerful incentive for the employee to keep his or her nose to the grindstone to keep the

employer afloat. But clouds were gathering on the pension horizon.

More than 30 years ago, I attended an academic conference at the time when the first clouds appeared. One of the paper presenters was wildly enthusiastic about the potential of a



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new type of pension plan called a Defined Contribution plan. In a Defined Contribution plan, the formula and guaranteed pension amount disappear. It is replaced by a promise from the employer to deposit a certain amount of money into a pension account. The pension is based on the amount in the account.

I jumped to my feet. "This is unconscionable," I shouted. (Young professors tend to be a bit loud.) "You are shifting the market risk from the

most sophisticated party to the transaction (the employer) to the least sophisticated party (the employee)." The response was essentially, "Shut up, kid - the employers love this." And well they should. Suddenly pension benefits were risk-free and the amount devoted to the pensions could be substantially less because there was no need to account for market fluctuations.

Defined Benefit plans were shut down all over the private sector. Cooperative government regulations and convenient accounting opinions decreed that the excess money in the shut-down Defined Benefit pension plans belonged not to the employees but to the employers. Grins were wide in the executive suites as they scooped millions of dollars of "excess" pension-plan money off the table and into their pockets.

Corporate negotiators totally outflanked the bewildered union negotiators, who agreed to the new plans without having a clue how they worked. Government minions went

(Way We Were, continued inside)

### IN THIS ISSUE:

- **The Way We Were**
- **From Near and Far**
- **Celebrating 65 Issues**

## FROM NEAR AND FAR



Christchurch, NZ – In February the huge earthquake that struck the South Island of New Zealand caused an estimated \$3 to 8 billion of insured losses. These estimates come from AIR Worldwide.



Moscow, Russia – A suicide bomber claimed the lives of 15 people and wounded 180 when he detonated a bomb at Moscow's Domodedova airport. According to a report in *Business Insurance*, the airport likely did not have terrorism coverage.



Brisbane, Australia – Flooding in the Australian state of Queensland has caused an estimated \$6 billion in insured losses. At least 20 people are feared to have died, and thousands were evacuated.



USA – According to AIR Worldwide, the winter storm that swept across the U.S. in February may have caused \$1.4 billion in insured losses in 30 states.



Kentucky – The State of Kentucky continues to grow as a domicile for captive insurance companies. The State issued 25 new captive licenses in 2010. It is now home to 127 captives.

(Way We Were, cont'd from cover)

along with the tide and set up special pension accounts for the investments of the employees. These were called 401(k) plans. The person assigning this label had a sardonic sense of humor. Every baseball fan knows that when scoring the game K is the signal for strikeout. So "401 strikeout" plans began to rule the land.

For the past two thousand years, every investigator has begun his or her analysis with the question *Qui bono?* Who benefits? The benefit to the corporate interests is obvious. There was another group that reaped huge benefits which, strangely, have been little commented on. It is our old friends, the stockbrokers. The sophisticated investment managers of the corporations were replaced by a swarm of naive, unsophisticated employee investors, most of whom

knew nothing about financial markets and cared less. Suddenly the flock of sheep waiting to be shorn covered the field of play all the way to the horizon. Did this swarm of uninformed private investors achieve the market perfor-

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mance of the pension managers they replaced? That is very doubtful. Did they, as a group, pay much more in investment commissions to the stock-

brokers than to the pension managers they replaced? As has been said in another context, "You betcha."

So what is there to complain about? The stockbrokers, whose well-being seems to be a high government priority, reaped the rewards. The corporations really put one over on their employees, winning a big one. Total funds going to employee pensions went down relative to what they would have been under Defined Benefit plans. The percentage of corporate funds going to executive compensation went up significantly. After all, to the victor go the spoils. Winners all around, right? Not exactly.

The corporate executives forgot one of the fundamental truths. You cannot sink half a ship. The employees whose pensions had become so precarious fill another important role in the economy. They are also consumers.

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(**Way We Were**, cont'd from opposite)

Employees whose future is highly risky consume less because they do not know what, if anything, will be left at the bottom of their 401(k) barrel when they can no longer work. As the population ages, the segment of society that is of retirement age, or is approaching it, is increasing daily. In economists' jargon, the marginal propensity of this group to consume is going down daily. Rather than being insulated from the vagaries of the stock market, they are imprisoned by it. These unsophisticated investors are constantly buffeted by every ripple in the stock market, in which they partici-

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pate against their will, with little understanding.

And here we are, in a recession and its slow recovery. The government keeps trying to improve consumer confidence, apparently forgetting that for a sizable percentage of the population, the old days are not only gone; they are not coming back. Government economists and advisors persist in treating the problem as a cyclical one. “Oh well, it is just the business cycle,” goes the song. Unfortunately it is becoming a dirge because there is an important structural element to the problem which no one is addressing. Substantial funds have shifted from the ranks of the corporate employees, who

have a high marginal propensity to consume, to the ranks of corporate executives, who have a low marginal propensity to consume. Missing some push for the economy from the consumer side, are we? I think we just found the leak.

More than 30 years ago, the Midwest was dotted with auto plants. These plants had large employee parking lots filled with row on row of gleaming new American-made cars. The dual role of the employee as consumer was pretty clear. Today the auto plants are shut down. The wind blows dust and weeds across the empty spaces where the gleaming employee cars once stood. Perhaps this isn't such a happy story after all.

How do we get back to *the way we were*? I do not think there is any simple answer to restoring the security of employee pensions and improving the performance of these employees as consumers. Globalization certainly does not help. Employees in India may cost less on that side of the ledger, but they are a total cipher when it comes to the consumer side. As far as the American economy is concerned, they simply are not there.

Perhaps the top *Fortune* 500 companies could lead the way by eliminating the Defined Contribution pension plans and replacing them with Defined Benefit plans. Possibly they could fund the increased cost by eliminating excess executive compensation.

Why have elected officials been slow to recognize these pension problems? It is difficult to truly understand something you are not experiencing. The last bastions of Defined Benefit pension plans are government agencies, including elected public officials. As a retired State of Califor-

nia employee, I am fortunate enough to enjoy a Defined Benefit pension plan.

There are many in the economy who are less fortunate. The lack of economic security in employee pension plans will act as a drag on the economy until the problem is remedied. A solution should be found, for the good of the economy and for humanitarian reasons, to reduce the gut-wrenching stress that financial difficulties place upon our aging population. It used to be that a good pension was a reward for many years of faithful service. Now the overpaid corporate executive, without putting down his Havana cigar

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or taking his feet off the desk, shoves a lottery ticket labeled “401(k)” across the desk to the retiring employee and says, “Good luck.”

The aggregation of less than good luck has caught up with the American economy. We are in the hole. Are we going to stop digging? **RRHA**

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This is the 65<sup>th</sup> issue of our free quarterly publication, *The RHA Review*. Who knew back in November 1994 that we'd still be publishing what we think is a quality newsletter in February 2011? A lot has happened in the world in the last 17 years. Soft insurance markets, hard insurance markets, a climb in insurance-related litigation, tort reform, terrorist attacks around the world and on home soil, catastrophic weather-related events, and many other newsworthy and not-so-newsworthy happenings.

Throughout this time we hope that you have enjoyed receiving and reading *The RHA Review*. We have grown from publishing and mailing about 500 copies of the first issue to regularly writing, editing, printing and mailing close to 2,500 copies each quarter. We are read, hopefully, in the United Kingdom, Canada, the Virgin Islands, Bermuda and here at home in the USA.

We hope that we can continue to do this for another 65 issues.

As an aside, if you have not done so already, you should go to [www.roberthughes.com](http://www.roberthughes.com) and check out our website. You can find information about our company and our group of consultants and experts. 

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