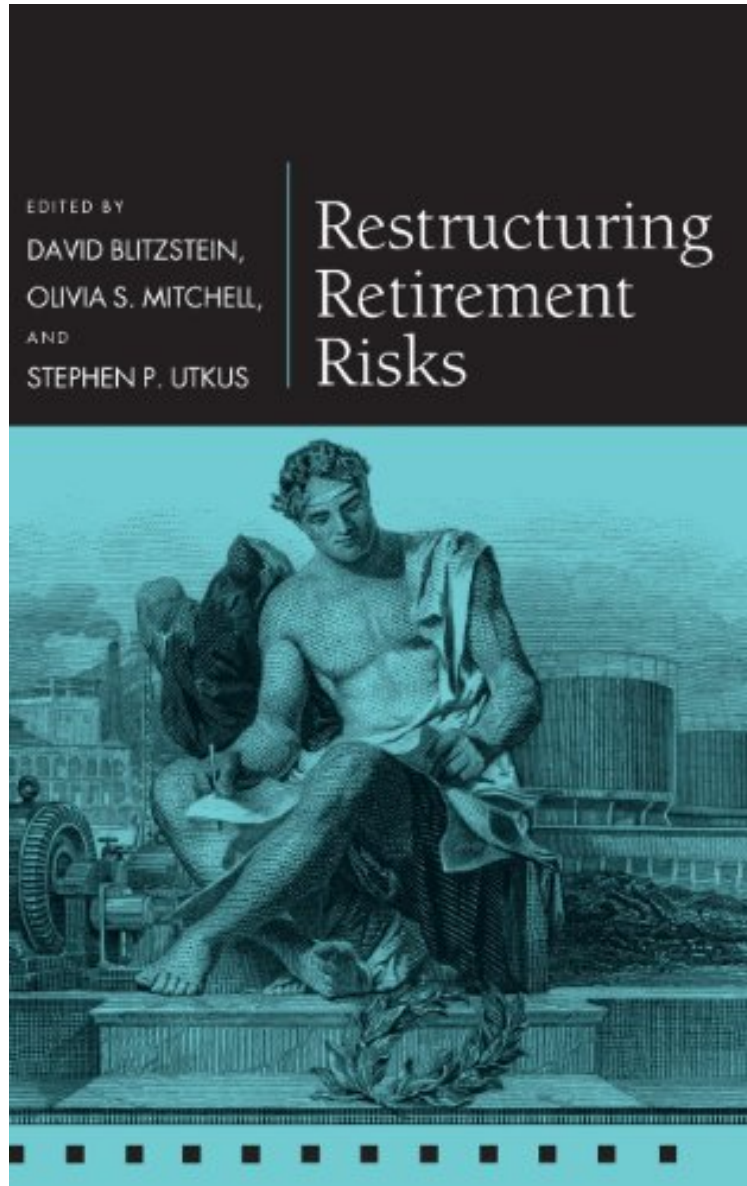


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Restructuring Retirement Risks (Pension Research Council Series)

David Blitzstein, Olivia S. Mitchell, Stephen P. Utkus
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GEORGE PENNACCHI University of Illinois This volume consists of 12 essays focusing on public as well as private pension systems, with an additional chapter containing a comprehensive analysis of financing retiree medical benefits by Wagoner, Rappaport, Fuller, and Yeager. The volume's essays are written at a level that is accessible to a non-academic audience, but their contents will also be valuable to researchers in the field of retirement security. Readers will come away with a deeper understanding of the challenges society faces in financing retirement expenditures. After an introduction, the book begins with an overlapping generations (OLG) model by Bohn who puts it through its paces to study intergenerational risk-sharing possibilities with respect to uncertain productivity growth, asset returns, fertility and longevity, medical technology and expenses, and war expenditure. The author examines how a government's ability to tax future generations on the behalf of more current generations, via institutions such as Social Security and Medicare, has the potential to improve risk-sharing vis-à-vis a laissez-faire system. The results provide interesting policy implications. For example, it may be optimal to more heavily tax a baby-bust generation to pay the social security benefits of their baby boom predecessors, since with a higher capital-to-labor ratio, the wages of the baby bust generation are relatively high. While this single-economy OLG model results are insightful, it would be interesting to extend it to the international context to consider how international risk-sharing might alter the recommendations. Several chapters analyze government policy with respect to private defined benefit (DB) pension plans. Work by Warshawsky, McCall, and Worth outlines regulatory flaws exacerbating the losses experienced by the Pension Benefit Guaranty Corporation (PBGC), the US government corporation insuring employer-provided DB plans. The chapter summarizes the economic justification for Bush Administration proposals to make DB plan accounting more transparent and reduce plan managers' moral hazard. The chapter by Hammond and Fore also emphasizes transparency, arguing that DB accounting rules should be standardized to make them market-value oriented. This, and targeting funding levels above full funding, would make DB pensions portable as in the Netherlands. Three chapters push further on how to manage risk in the DB environment a range of countries. Coronado and Liang employ an empirical model to confirm that PBGC-insured plans in the US engaged in moral hazard. They find that, as corporate sponsors of DB plans became more financially distressed, their contributions to their DB plans declined, thereby increasing plan underfunding and, ultimately, raising PBGC losses. Turning to the UK, McCarthy and Neuberger present a stochastic model of that government's recently established Pension Protection Fund (PPF) which, like the PBGC, insures private defined benefit plans. The authors calculate fair insurance premia sufficient to cover taxpayer losses due to plan failures, but they then assess the probability that extreme losses from providing DB guarantees would wipe out the PPF's reserves. Taking as a base case the pension fund of the European Central Bank pension, Albrecht, Coche, Maurer, and Rogalla also analyze alternative guarantees on returns of hybrid pension plans that combine elements of DB and defined contribution (DC) plans. Again, they focus on the probability of extreme losses from providing such guarantees. While potentially useful for risk management, the emphasis on extreme losses detracts from the arguably more important issue of determining the market value of these guarantees, a value that can be derived using contingent claims (option pricing) theory. Several other chapters in this volume consider the economics of DC plans. Borzi's essay takes a rather negative view of DC plans because they place more responsibility for retirement savings on employees. But given the poor performance of many DB plans, including the lack of portability and losses of benefits due to bankruptcies, it is unclear that DC plans are actually riskier than DB ones. This discussion drives the need to appropriately design DC plans, a topic taken up by Mitchell, Utkus, and Yang who analyze more than 500 401(k) plans. They find that U.S. tax laws and plan regulations give plan sponsors an incentive to be more generous in matching employee contributions when the average employee is a relatively high-paid individual. Holden and VanDerhei simulate retirement payouts from 401(k) plans, and they find that even lower-paid employees who make continuous 401(k) contributions and who do not retire early achieve relatively high retirement incomes. This is especially true when their DC savings are combined with Social Security benefits. But employees not continuously enrolled in 401(k) plans and who fail to contribute to IRA accounts during times of non-enrollment can fall short of retirement security. The authors also note that "catch-up" contributions available to employees over the age of 50 have the largest impact on higher wage individuals' retirement incomes. One of the more intriguing essays in this volume is by Valde's-Prieto, who presents a theoretical argument for converting a Pay-As-You-Go (PAYGO) defined benefit Social Security scheme into a DC individual account system. His plan, which is worthy of serious consideration, overcomes a potential political roadblock by eliminating transition costs associated with the conversion. This is done by recognizing that additional future payroll taxes and/or benefit cuts implicitly exist under the current PAYGO system. Cash flows from making these additional taxes explicit can be securitized as Covered Wage Bill (CWB) securities and issued to social security beneficiaries at their market values. These wage-based securities could then be held in individuals' private accounts whose value is increased by regular payroll contributions, or they can be traded for shares in a limited menu of balanced mutual funds.

This book highlights the importance of retirement security as a major policy concern of our time. A generation of "Baby Boomers" is on the verge of retirement, yet pension systems confront crushing challenges, and policymakers

seek direction. The authors set their sights on employees' needs and expectations, employers' intentions and realizations, and policymakers' efforts to resolve the many challenges. Despite the fact that retirement systems face deep stresses exacerbated by volatile capital markets, poor corporate earning streams, weak macroeconomic performance, and international turmoil, nevertheless, contributors in this volume show courage and creativity in plotting the course over uneven terrain. In the book, three aspects of the evolution of risk and reward-sharing in retirement are evaluated, to offer guidance to pension fiduciaries, plan participants, and policymakers. First, the volume formulates new perspectives for assessing retirement risks and rewards. Second, it evaluates efforts to insure retirement plans. Third, it proposes several new strategies for managing retirement system risk. The volume will be especially useful for managers working toward more efficient pension plans; to scholars and policymakers seeking to maximize pension design effectiveness; and to actuaries and tax specialists concerned with pension regulation.

About the Author David Blitzstein is the Director of the United Food and Commercial Workers International Union (UFCW) Negotiated Benefits Department where he advises local unions in collective bargaining on pension and health insurance issues and consults with the Union's 150 jointly trusted health and welfare and pension plans nationwide. Mr. Blitzstein also serves as trustee of the UFCW Industry Pension Fund, and the UFCW National Health and Welfare Fund. Mr. Blitzstein represents the UFCW as a member of the working committee of the National Coordinating Committee for Multiemployer Plans. In addition he serves on the Pension Research Council Advisory Board at the Wharton School; he is a member of the Employee Benefits Research Institute and the National Academy of Social Insurance. He received the BS degree from the University of Pennsylvania and he received the MS in Labor Studies from the University of Massachusetts in Amherst. Olivia S. Mitchell is the International Foundation of Employee Benefit Plans Professor of Insurance and Risk Management, the Executive Director of the Pension Research Council, and the Director of the Boettner Center on Pensions and Retirement Research at the Wharton School. Concurrently Dr. Mitchell is a Research Associate at the National Bureau of Economic Research and a Co Investigator for the AHEAD/Health and Retirement Studies at the University of Michigan. Dr. Mitchell's main areas of research and teaching are private and public insurance, risk management, public finance and labor markets, and compensation and pensions, with a US and an international focus. She received the BA in Economics from Harvard University and the MA and PhD degrees in Economics from the University of Wisconsin-Madison. Stephen P. Utkus is the Director of the Vanguard Center for Retirement Research, where he conducts and sponsors research on retirement savings and retirement benefits. His current research examines attitudes and expectations regarding retirement, financial markets and employer-sponsored retirement plans; the psychological and behavioral aspects of participant decision-making; trading and investment behavior among retirement plan participants; fiduciary issues arising from retirement programs; and global trends in public and private pension plans. Mr. Utkus serves on the Pension Research Council Advisory Board and he is also a Visiting Scholar at the Wharton School. He received the BS in Computer Science from MIT and the M.B.A. in Finance from The Wharton School.