

Topics in Investments – B40.3176

The Role of Finance in Providing for Income and Health Care in Retirement and Growing Investment Funds Related to Retirement

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Tuesday 6-9 pm, Spring 2007, 1st Half

Introduction and Purpose

The United States is confronted with multiple intractable problems in financing retirement in the upcoming decades: (1) a burgeoning senior population with baby boomers ill prepared financially for retirement, (2) relentless rising medical care costs, exacerbated by the higher cost of an older population, (3) a reluctance of Corporate America to continue either generous of traditional retirement plans or post retirement medical care and (4) a population generally not prepared to manage a long term financial plan requiring saving and careful provision for distant income and medical needs; and in addition, not educated to manage the investment portfolio needed to finance that plan.

Leading companies' (Ford, GM) very existence is threatened by looming legacy costs of their retirement promises. Others cannot compete in global markets with conventional pension arrangements (IBM, Lucent, AT&T). Accounting standards are focusing immediate attention on unfunded liabilities.

At the government level, it is clear that projected costs of Medicare and Medicaid will swallow up all our tax resources. Cutbacks are inevitable. In a few decades personal "out-of-pocket" medical costs will devour family discretionary spending.

The purpose of the course is to describe rigorously the role of finance and investments in planning to cope with these major problems. We explore each of the three pillars that supports income needs and costs in the future:

- Pillar I. The Government in providing Social Security, Medicare, and Medicaid, welfare as well as backing up employer defined benefit plans through the Public Benefit Guaranty Corporation.
- Pillar II. Employers, in providing pension benefits through defined benefit and defined contribution plans (401k), managing the asset portfolios underlying those plans, and providing post retirement medical care and nursing home provision.

Pillar III. The family through personal savings (IRA's, mutual funds, annuities, Keogh plans and other means) to cover income needs, and medical care post retirement and long term care.

We will examine the variety of instruments and institutional arrangements that can meet individual and corporate obligations.

We will also explore demographic and economic developments that can be predicted over the next 20 to 50 years.

The course is designed for those who will be CFO's responsible for corporate retirement plans, research analysts interested in the impact of corporate retirement plans on future earnings, human resources officers, and for those interested in a future professional career in financial planning (actuaries, personal financial planners, compensation experts, etc.) and for anyone planning to have a well financed one-quarter of his or her life lived in retirement.

Books and Readings

Pension Planning, Pension Profit-Sharing and Other Deferred Compensation Plans, Allen, Melone, Rosenbloom and Mahoney, McGraw Hill, 2003.

Coming Up Short, The Challenge of 401(k) Plans, Munnell and Sundén, Brookings Institution Press, 2004.

Restoring Fiscal Sanity, 2005 Meeting the Long Range Challenge, Rivlin and Sawhill, Brookings Institution Press.

Student Tasks

Students are expected to come to class having studied the readings assigned for the session, and to participate in discussion with the instructor and guest speakers.

Two brief papers (2 pages) will be required examining such issues as:

- (1) Develop a model for determining the optimal use of a traditional IRA, Roth Ira or direct mutual fund; taking into account varying asset returns and tax rates, both before and after retirement.
- (2) Outline an optimal investment policy for the assets backing a corporate defined benefit pension plan, taking into account the GAAP reporting requirements.

- (3) How can an employer construct a plan for employee post retirement medical care benefit without incurring unacceptable future obligations.
- (4) Examine the optimal way for families with different income and wealth levels to provide for potential significant costs of nursing home care
- (5) Design a cash balance pension plan to replace a traditional corporate defined benefit plan. The plan must meet IRS qualification requirements and not disadvantage any existing older employees.

Grading:

One half on two papers
 One half on the final exam

Speakers:

Consulting Actuary (Corporate pension plan design)
 A Trustee of the U.S. Social Security system

Session Outline:

1. General scope of retirement issues.
 History of pension plans.
 Projections of government obligations, medical care costs and amounts required for retirement.
 Outline primary design issues for pension plans – instruments: defined benefit vs defined contribution
 History and tax changes for individual savings for retirement.
 Instruments: IRA's, SIMPLE Plans, Roth and traditional.

Assigned Readings (Session 1)

AMRM Chapters 1, 2, 3
 Rivlin & Sawhill pp 1-17
 Readings (Phi Beta Kappa Address on Pension Plans)
 Summary of 2006 Private Pension Protection Act)

2. Advantages and Limitation of Defined Contribution plans.
 Incentives for retirement.
 Adequacy of Baby Boomers Planning – accumulated assets, inheritance, government support.

First Paper Assignment.

Assigned Readings (Session 2)

AMRM Chapters 4 and 5 (skim)
Chapters 6, 11
Munnell & Sundén – Chapters 1 and 2
Readings (Reform of Qualification Rules)

3. Financial management of corporate pension plans.
Fundamental actuarial elements of defined benefit plans.
Alternative investment strategies for assets (Leibowitz).

First Paper Due

Speaker: Corporate actuary

Assigned Readings (Session 3)
AMRM Chapters 13, 14, 15, 22, 23 & 24, 26
Readings (TBD)

4. The government pillars: Social Security, Medicare, Medicaid
Description of benefits in each. How to compute PIA's, related benefits.
Disability benefits.
Financing problems for each.
PBGC's role in defined benefit plans. Moral hazard.

Speaker: Trustee of Social Security system

Assigned Readings (Session 4)

AMRM Chapters 16, Appendix I and IA
Rivlin and Sawhill, Chapters 2 and 3
Reading (TBD)

5. Post Retirement Medical Care
Projection of mortality and morbidity, and medical care costs.
Limitations of Government and Corporate pillars.
Personal and employer supported supplemental policies.
Long Term Care insurance
Defined Contribution Plans(VEBA's and HSA's)

Second Paper Assignment

Assigned Readings (Session 5)

Rivlin and Sawhill Chapter 4
Readings (Change article, LTC)

6. Personal strategies for coping with retirement plans.
Employer obligations, risks and benefits.
Implications of the weakening of the first two pillars.

Second Paper Due

Assigned Readings (Session 6)

AMRM Chapters 17, 18, 20, 27
Rivlin and Sawhill Chapter 6
Munnell and Sundén Chapters 4, 8

7. Final Examination (TBD)