GREAT LAKES ADVISORS
THE PENSION PROMISE
SESSION ONE

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A Presentation to the:
National Conference on Public Employee Retirement Systems
Trustee Educational Conference 2016
THE PENSION PROMISE

Session One – History, Evolution & Mechanics

• This session, designed for new trustees, provides a brief history of welfare and insurance plans and their evolution into the annuity and retirement plan structures. In addition, the session will seek to provide a basic understanding of the terminology, mechanics and legal framework applicable to pension plans.
PENSION HISTORY AND EVOLUTION
SOCIAL PROMISE

• Society commits to providing poverty protection to workers who are no longer able to work due to age or disability.

CAREER PROMISE

• Employees commit to working for an ‘Entity’ during their working career, the ‘Entity’ agrees to provide life time deferred earnings for when they can no longer work.

PUBLIC SAFETY PROMISE

• Public Safety Officers agree to sacrifice their lives and/or well being to protect the Community they serve; in turn the community agrees to protect them, as well as their families, from the risks associated with this commitment.

WHAT PROMISE?

• Globalization has virtually eliminated the ‘Job for Life’ from the private sector
• Mobile work force has created the desire for ‘Portability’
• “Pay me now!” A mentality that we are better educated and more financially savvy than previous generations
• Political shift to an ‘Ownership Society’ where individuals are expected to bear greater risk and responsibility for their health and retirement costs
WORLD

• Roman empire to the early-modern nation state
  • Pensions for public workers and military pensions, in particular, have a long history and have been used as a key element to attract, retain, and motivate personnel throughout time.

• Vagabonds and Beggars Act 1445
  • Imprisoned beggars, made poverty a quasi criminal act.

• Brehon Law
  • Middle ages - imposed, a legal responsibility for the ‘community’ to provide for the aged, blind, deaf, sick and the insane.

• Widows’ and Orphan Funds
  • Documented back to 1645 in Germany. Originally established for clergy, and later expanded to teachers.

• Old Age and Disability Insurance
  • Started in the 1880’s in Germany and England to provide a pension annuity. Financed by a tax on workers. Original retirement age was set at 70, and eventually lowered to 65 in 1916. Average European life expectancy was 45 in 1916.

• The National Insurance Act (Greater Europe Standard)
  • 1940’s system resembling Social Security

UNITED STATES - PUBLIC PENSIONS

- Public Pensions for disabled military personnel predate the signing of the Constitution (1775).
  - If a soldier left honorably (termed severance), was killed in action or died in the service, he or his widow or heir(s) would receive 160 acres of land from the military reserve. The reservation price of public land at that time was $2.00 per acre. So, the severance package would have been worth $350, which, annuitized at six percent, would have yielded less than $2.00 a month in perpetuity.

- First recorded ‘regular’ retirement was for Civil War Veterans
  - Established 30 years as the minimum service requirement, 75 percent of base pay as the standard pension, and age 64 as the mandatory retirement age. This was the basic army pension plan until 1920.
  - Funded on a "pay-as-you-go" basis from the general revenues of the U.S. Treasury.

- First Public Pensions limited to (3) groups: police officers, firefighters, and teachers
  - New York City established the first such plan for its police officers in 1857. Like the early military plans, the New York City police pension plan was a disability plan until a retirement feature was added in 1878
  - The Chicago Police Pension Fund in 1912 reported: "It is to be regretted that there are no complete statistical records showing the operation of this fund. . . . It is hard to imagine that the records were simply misplaced by accident" (Clark, Craig, and Wilson 2003, 213)

- 1920 Civil Service Retirement System formed to provide retirement, disability and survivor benefits to civilian federal workers

UNITED STATES – PRIVATE SECTOR

• Industrial Pensions – Railroad, Banking and Public Utilities
  • 1875 American Express Company is the first private employer to provide a “Traditional” defined benefit plan.
  • B&O Railroad in 1880 was the first to jointly finance a formal ‘Plan’ with employer and employee contributions. The railroad had been in existence for over 50 years! Other railroads shortly followed suit.

• Insurance Annuities
  • 1921 Metropolitan Life issues the first group annuity contract. This contract provided the structure for pooling assets and risk under a life based annuity framework for a group of employees.

• Internal Revenue Act
  • Enacted in 1921 and clarified in 1926, the Act provided that contributions to ‘Qualified’ Pension Trusts would be exempt from Corporate Income Tax, and earnings and contributions would not be taxable to the beneficiaries until actually distributed.
  • By 1930, 20% of all labor union members and 1/10 of all workers were covered by a pension plan
  • All were discretionary – employers could modify, suspend or annul the pension program at any time.

Evolving Legislation

- Federal Insurance and Contribution Act (F.I.C.A.)
  - Passed 1935 as a payroll tax used to fund Social Security and Medicare
  - No mandate for retirement savings, disability insurance or disability/survivor income existed.
  - Medicaid for elderly health care passed 1960

- Employee Retirement Income and Security Act (E.R.I.S.A.)
  - Federal Law enacted 1974, resulted from strong public opinion arising from the Studebaker Corporation’s failure to pay pensions to its 7600 vested retirees.
  - Establishes minimum standards for pension plans in private industry and provides for extensive rules on the federal income tax effects of transactions associated with employee benefit plans:
    - Requiring the disclosure of financial and other information concerning the plan to beneficiaries;
    - Establishing standards of conduct for plan fiduciaries;
    - Providing for appropriate remedies and access to the federal courts.
  - Created Pension Benefit Guarantee Corporation

**Evolving Legislation**

- The Revenue Act of 1978
  - Included a provision that became Internal Revenue Code (IRC) Sec. 401(k) (for which the plans are named), under which employees are not taxed on the portion of income they elect to receive as deferred compensation rather than as direct cash payments. The Revenue Act of 1978 added permanent provisions to the IRC, sanctioning the use of salary reductions as a source of plan contributions. The law went into effect on Jan. 1, 1980. Regulations were issued in November of 1981.
  - Employees (known as 457 plans) and nonprofit-sector employees (known as 403(b) plans). The outside law firm for Hughes Aircraft Company recommends that the company begin the process of amending its savings plan to adopt the new 401(k) feature.


GLORY DAYS PASS YOU BY!

• In 1980
  • 80% of all full time workers were covered by a defined benefit plan
  • 16% by a defined contribution plan
• In 2015*
  • 14% of all full time workers were covered by a defined benefit plan and a defined contribution plan combination, only 4% where a defined benefit is the sole offering
  • 36% are represented by a union (7% of the private workforce)
  • Only 47% are offered participation in a 401k defined contribution plan
• Pension Protection Act
  • Passed 2006, provided for 100% vesting of contributions in defined contribution plans
  • Established standards and requirements for defined benefit funding
• Patient Protection & Affordability Act
  • Passed 2010
  • First step to mandate nationalized health insurance
• Detroit declares bankruptcy!
  • Legitimizes trend to default on existing benefit promises
• GASB 67 & 68 Reporting Requirements
  • Transparency of liability and discount rates

PENSION MECHANICS
QUALIFIED PLAN
• The term qualified has special meaning regarding defined benefit plans. The IRS defines strict requirements a plan must meet in order to receive favorable tax treatment, including:
  • A plan must offer a Single Life Annuity (SLA) and a Qualified Joint & Survivor Annuity (QJSA)
  • A plan must maintain sufficient funding levels
  • A plan must be administered according to the plan document
  • Benefits are required to commence at retirement age
  • Once earned, benefits may not be forfeited
  • A plan may not discriminate in favor of highly-compensated employees
  • Failure to meet IRS requirements can lead to plan disqualification, which carries with it enormous tax consequences

NON-QUALIFIED PLANS
• 403(b) & 457 plans are not considered qualified plans, but are treated and taxed almost identically
• Tax deferred savings accounts, SEP, SIMPLE and Rabbi Trusts
PENSION

• Fixed sum paid regularly to a person following a retirement from service, typically in the form of a guaranteed life annuity
• Set up by Employers, Insurance Companies, Employer Associations and Trade Unions
• Terms are pre-determined, legal and/or contractually binding
• Disability and survivor benefits are typically structured as insurance – ‘Event Based’

DEFINED BENEFIT PLAN—Created under US, 26 U.S.C. 414(i)

• Terms of the benefit are defined and not variable
• ‘Traditional’ DB is final or average salary (FAP), creditable service (accrual rate), and age
• Pooled Risk – investment, life span, event, work longevity, inflation
• Hybrid plans attempt to create a notional or hypothetical account inside of a DB structure
  • Deigned to shift risk or modify group behavior

DEFINED CONTRIBUTION PLAN

• Individual ownership, risk & responsibility
• Benefits are based solely on an account balance
• Heavily regulated by the Internal Revenue Service and the Department of Labor
• Target benefit plans attempt to mirror (resemble) defined benefit structures within individual account format
INSURANCE

• A contract formed for the purpose of covering certain types of events for a usually related group of stakeholders. Insurance involves:
  • Risk Shifting: Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer.
  • Risk Distribution: Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single claim will exceed the amount taken in as individual payment.
  • Asset Protection: Assets are generally not subject to creditors’ claims and are held in Trust.

• Primary reasons to Self Insure:
  • Lower cost
  • Obtain protection not otherwise available
  • Custom design
  • Investment potential of reserve
  • Control of the claims process

MECHANICS

- Retirement schemes are structured around four macro design choices:
  - Payroll Taxes (Employer & Employee)
  - Deferred Earnings (Employer)
  - Deferred Earnings and Savings (Employee)
  - Savings (Individual)

RETIREMENT SHOULD BE FINANCED BY A COMBINATION OF THE ABOVE:

- To achieve this, the employee needs career long earnings deferral and savings
  - Social Security is designed to provide a 33% wage replacement rate
  - Retirement experts recommend an 83% wage replacement rate for an equivalent standard of living (50% gap to Social Security)
  - 125% wage replacement rate, if retiree will be without access to employer subsidized health care
  - Retirement schemes are structured around four macro design choices

PAYROLL TAXES

- Social Security is a DEFINED BENEFIT
- Goal is a LIVING WAGE REPLACEMENT
- When & How much?
  - VESTING (qualifier) based on Age, Service Quarters or Event
  - Benefits are defined based on SALARY AND AGE
- How Long? LIFE TIME

DEFERRED PAYROLL (EARNINGS)

• **DEFINED BENEFIT PLAN** (SALARY, AGE & SERVICE CREDIT)
  • Employer Sponsored
  • Form of Deferred Compensation
  • Income Tax Deferred
  • Pooled Assets and Risk Distribution
  • Employer Bears Investment Risk
  • Dynamic Funding Requirements

• Goal is a **% WAGE REPLACEMENT**

• When & How much?
  • Vesting (qualifier) based on formulary of Age, Creditable Service or Event
  • Similar to Group Insurance Annuity - Insurance benefit is defined by the dollar amount, not employment conditions, which would preclude this from being a defined benefit

• How Long? **LIFE TIME**

Source: National Conference on Public Employee Retirement Systems, "The Evolution of Public Pension Plans"
DEFERRED PAYROLL (EARNINGS)

- DEFINED CONTRIBUTION - 401(k) PLANS, PROFIT SHARING, KEOGH, ESOP, SIMPLE, ETC.
  - Employer Sponsored
  - Form of Deferred Compensation
  - Static Contributions (if applicable)
  - Tax Deferred Investment
    - Ownership/Control/Hardship & Loans
  - Self Directed Investments
    - Risk shifts to the employee
  - Goal:
    - Wage replacement
    - Portability
    - Competitive rate of return
  - When & how much? Optimal account balance & age
  - How long? Unknown

DEFERRED PAYROLL (EARNINGS)

- HYBRID DEFINED BENEFIT PLAN (Mimics similar features of a defined contribution plan)
  - Employer Sponsored
  - Form of Deferred Compensation
  - Income Tax Deferred
  - Pooled Assets and Risk Distribution
  - Employer Bears Modified Investment Risk
    - Investment risk determined by plan design
    - Funding requirements dependent on plan design
  - Types – usually an addendum or a conversion to/from an existing DB Plan
    - Reciprocity, Lump Sum (DROP), Flexible COLA provisions, etc.
    - Cash Balance Plan, Money Purchase Plan, Minimum Balance Plan, etc.
  - Goal
    - Flexibility
    - Ownership
    - Level or predictable funding requirements

TAX DEFERRED EARNINGS, TAX DEFERRED SAVINGS & TAXABLE SAVINGS

• EMPLOYER SPONSORED
  • Form of Deferred Compensation or Savings
  • Income Tax Deferred
    • Non Qualified Plans: Top Hat, 457, 403(b)
• TAX DEFERRED (SAVINGS) ACCOUNTS
  • IRA (Roth & Traditional)
• TAXABLE SAVINGS ACCOUNTS
• Goal:
  • Supplemental income
  • Wealth accumulation
  • Competitive rate of return

QUESTIONS

1. Do you know when your pension plan was enacted?
   a. Yes
   b. No

2. More than 50 years ago?
   a. Yes
   b. No

3. What is the primary difference between a defined benefit plan and a defined contribution plan?
   a. Cost to the Employer
   b. Investment Return
   c. Investment Risk
   d. Amount set aside at Retirement

4. What is the primary advantage of a defined contribution plan?
   a. Better Benefits
   b. Real Money
   c. Portability
   d. Higher Investment Returns

5. Would you trade your DB for a DC Plan?
   a. Yes
   b. No

6. As part of your public sector employment do you pay into social security?
   a. Yes
   b. No

7. As part of your public sector employment do you have access to a 457 Plan or other type of deferred contribution plan?
   a. Yes
   b. No

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- Kelly is the Managing Director of Client Service and Sales for Great Lakes Advisors, LLC. With over 20 years of experience in the financial and investment business, he specializes in investment solutions for public, corporate, and multi-employer retirement plans. A former public fund trustee and lobbyist, Kelly brings a strong investment background and practical retirement plan experience to our clients.

Prior to joining Great Lakes Advisors, LLC, Kelly held positions with PNC Capital Advisors, LLC, and JP Morgan Asset Management Company. He received his undergraduate degree in accounting from Illinois College, an MBA from the University of Illinois, Springfield, and is a Certified Public Accountant (not in practice).

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