GREAT LAKES ADVISORS
HISTORY, EVOLUTION & MECHANICS OF RETIREMENT PLANS

PRESENTED BY:

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DISCUSSION TOPICS

HISTORY, EVOLUTION & MECHANICS OF DEFINED BENEFIT PLANS

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 retirement plan structures.
ANCIENT WORLD HISTORY

- **Retirement schemes date back to the Roman Empire**
  - Pensions for public workers and military personnel, in particular, have a long history and have been used as a key element to attract, retain, and motivate personnel throughout time.

- **Middle (Dark) Ages**
  - Vagabonds and Beggars Act - Imprisoned beggars, made poverty a quasi criminal act.

- **Enlightenment**
  - Brehon Law - Imposed, a legal responsibility for the ‘community’ to provide for the aged, blind, deaf, sick and the insane.
  - Genesis of ‘Widows and Orphan’ Funds
  - Retirement schemes were established for clergy, and later expanded to teachers.

- **Early Industrial Period - 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
HISTORY

UNITED STATES - PUBLIC SECTOR

• **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. Land was in abundance, but what do you do with it if your disabled?

• **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: 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.
  • 1920 Civil Service Retirement System formed to provide retirement, disability and survivor benefits to civilian federal workers.
HISTORY

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.
  - All were discretionary – employers could modify, suspend or annul the pension program at any time.
EVOLUTION

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 prior mandate for retirement, 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
EVOLUTION

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.

SHIFTING FROM DEFINED BENEFITS TO DEFINED CONTRIBUTIONS

In 1980
- 80% of all full time workers were eligible for a traditional retirement plan
- Over 38% were in a traditional defined benefit plan

Most Recent Data¹
- 13% of private sector workers were covered by both a defined benefit plan and a defined contribution plan combination
- Only 2% of private sector workers participated in a defined benefit as a sole offering and 33% where a 401(k) was the sole offering
- Less than 50% of private sector workers are offered participation in some form of retirement plan

Pension Protection Act
- Passed 2006, provided for 100% vesting of contributions in defined contribution plans
- Established standards and requirements for defined benefit funding

GASB 67 & 68 Reporting Requirements
- Transparency of liability, expected returns, and discount rates
- Bankruptcy is now a potential concern for the public sector defined benefit plan
MECHANICS

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, 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 qualified
- Pooled Risk

DEFINED CONTRIBUTION PLAN
- Individual ownership, risk & ‘personal’ responsibility
- Benefits are based solely on an account balance
- Singular Risk
- Both Defined Benefit and Contribution Plans are heavily regulated by the Internal Revenue Service and the Department of Labor
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
MECHANICS

INSURANCE

• A contract formed for the purpose of covering certain types of events for a 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 payment.
  • **Asset Protection**: Assets are generally not subject to creditors’ claims and are held in Trust.

• **Reasons to Self Insure (Public DB Plans):**
  • 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 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
MECHANICS

PAYROLL TAXES

SOCIAL SECURITY

• Goal - **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

DEFERRED PAYROLL (EARNINGS)

DEFINED BENEFIT PLAN

• Employer Sponsored
• Deferred Earnings
• Income Tax Deferred
• Pooled Assets and Risk Distribution
• Employer Bears Investment Risk
• Dynamic Funding Requirements

• Goal - **WAGE REPLACEMENT**
• When & How much?
  • Vesting (qualifier) based on formulary of Age, Creditable Service or Event
• How Long? LIFE
MECHANICS

DEFERRED PAYROLL (EARNINGS)

DEFINED CONTRIBUTION - 401(k)

- Employer Sponsored
- Deferred Earnings
- Income Tax Deferred
- Defined Contribution Rate
- Self Directed Investments
  - Risk shifts to the employee
  - Ownership/Control/Hardship & Loans
- Goal:
  - Wage replacement
  - Portability
  - Competitive rate of return
- When & how much? Optimal account balance & age
- How long? Unknown
MECHANICS

TAX DEFERRED SAVINGS & TAXABLE SAVINGS

TAX DEFERRED GROUP ACCOUNTS
- Non Qualified Plans: 457 & 403(b)
  - Employer Sponsored
  - Deferred Earnings
  - Income Tax Deferred

TAX DEFERRED SAVINGS ACCOUNTS
- IRA (Roth & Traditional)
  - Income Tax Deferred on Investment Earnings
- Goal:
  - Supplemental income
  - Wealth accumulation for inheritance
  - Competitive rate of return
BIOGRAPHY

Kelly Weller
Managing Director

Kelly Weller is a Managing Director of Client Service and Sales for Great Lakes Advisors and serves as a client relationship manager for the firm. Kelly began his industry career in 1994 and specializes in investment solutions for public, non-profit, corporate, and multi-employer endowment, foundation, and retirement plans.

Prior to joining the firm in 2012, he held similar positions with PNC Capital Advisors, LLC and JP Morgan Asset Management Company. As a former public fund trustee and current Board Advisor to the National Conference on Public Employee Retirement Systems, Kelly brings a deep relationship network and practical experience to the client service team.

Kelly holds a bachelor’s degree from Illinois College, an MBA from the University of Illinois (Springfield), and is also a Certified Public Accountant. He also holds FINRA Series 7, 63, and 65 Licenses.

ABOUT GREAT LAKES ADVISORS

Founded in 1981, Great Lakes Advisors is headquartered in Chicago, Illinois with an additional office in Tampa, Florida. The firm has $9 billion in assets under management and advisement and offers a wide range of fixed income and equity strategies across all market capitalizations. We have deep portfolio management capabilities within ESG, Socially Responsible, Tax-Managed, and Customized account solutions. Our clients include public funds, multi-employer plans, corporations, religious communities, endowments/foundations, health care plans, and private wealth management clients.
DISCLOSURES

Sources:
• Rev. Rul. 2002-90, 2002-2 C.B. 985

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