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, pension and insurance plans and their evolution into the annuity and retirement plan structures of today. In addition, the session will seek to provide a basic understanding of the terminology, mechanics and legal framework applicable to retirement plan structures.
THE PROMISE

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’
  • The U.S. Bureau of Labor Statistics reports average employee tenure is 4.6 years (2014)
• ‘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

Sources: The History of Retirement Benefits: James Tehrani - June 21, 2016,
HISTORY

WORLD HISTORY

Antiquity
• Pensions, in the broadest sense of the term, have existed since ancient Rome; soldiers in the Roman army could earn pensions through their military service. Pensions for military service have continued to exist in one form or another in the two thousand years since.

Dark Ages
• Vagabonds and Beggars Act - Imprisoned beggars, made poverty a quasi criminal act.

Renaissance, Reformation and Enlightenment (1400 AD to 1800 AD)
• Brehon Law (Keltic)
  • Imposed, a responsibility for the ‘community’ to provide for the aged, blind, deaf, sick and the insane.
  • Whoever comes to your door you must feed and care for.
  • When you become old your family must provide you with one oatcake a day plus a container of sour milk. They must bathe you every 20th night and wash your head every Saturday. Seventeen sticks of firewood is the allotment for keeping you warm.
• Widows and Orphan Funds were established (Duke Earnest the Pious)
• Retirement schemes were established for Clergy, and later expanded to Teachers.
• Many aspects prevail in English Common Law today (Not-For Profits and Charities)

Industrial Revolution (1750 AD to 1900 AD)

- Europe - Old Age and Disability Insurance (Otto Bismarck)
  - Started in the 1880’s in Germany and England to provide a pension (life) 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.

Age of Globalization

- The National Insurance Act (Greater Europe Standard) – 1940’s
  - Abolished the ‘Poor Law of 1834’
  - Current European 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, the 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 you are disabled?

- **First recorded ‘regular’ retirement was for Civil War Veterans**
  - Established 30 years as the minimum service requirement, 75% of base pay as the standard pension, and age 64 as the mandatory retirement age.
  - 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

• **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.
  • 1899 – There were 13 private pension plans in the U.S. (Life expectancy was approximately 49).

• **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.

• **The 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.)**
  - Enacted 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 people with limited income and resources offers benefits not normally covered by Medicare, including nursing home care and personal care services, enacted 1965

• **The Labor-Management Relations Act of 1947**
  - Provides fundamental guidelines for the establishment and operation of pension plans administered jointly by an employer and a union.
  - Labor unions in the 1940s became interested in pension plans and pushed to increase the benefits offered. By 1950 about 25 percent of the private sector workforce had a traditional pension. Ten years later in 1960, about half of the private sector workforce had one.

Sources: A Timeline of the Evolution of Retirement in the United States Workplace Flexibility 2010, Georgetown University Law Center, History of the Pension Plan: Mellissa Phipps - Updated January 28, 2019
**EVOLVING LEGISLATION**

- **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](https://www.gpbc.com/)

EVOLUTION

EVOLVING LEGISLATION

• The Revenue Act of 1978
  • Included a provision that became **Internal Revenue Code (IRC) Sec. 401(k)**, under which employees are not taxed on the portion of income they elect to receive as **deferred compensation (DC)** 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.
  • 1979-1982—Several companies - develop 401(k) plan proposals, many of which officially began operation in January 1982.

EVOLUTION

Evolving Legislation

• Pension Protection Act
  • Passed 2006, provided for 100% vesting of contributions in defined contribution plans
  • Established standards and requirements for defined benefit funding
  • Allows for automatic enrollment in Code Section 401(k) plans

• GASB 67 & 68 Reporting Requirements
  • Transparency of liability, expected returns, and discount rates for public sector benefit plans
  • Bankruptcy becomes a potential concern for the public sector defined benefit plan

• The Retirement Enhancement and Savings Act (RESA) of 2019
  • A bipartisan bill, H.R. 1007, which will provide U.S. workers increased opportunities to participate in an employer-provided retirement plan. It would remove restrictions that allow small businesses to band together in a Multiple Employer Plan so they achieve economies of scale and make it easier for employers to offer a retirement plan to workers. Ignites

Sources: Wikipedia – Pensions, History of Pensions,
SHIFTING FROM A DEFINED BENEFIT TO A DEFINED CONTRIBUTION CULTURE

• The three "legs" of the retirement "stool" (private savings, pensions, and Social Security) are all in dire shape.

  • After looking at the data, the St. Louis Fed concluded: "It could be worrisome that, for many American households, the total balances of their retirement accounts may not be sufficient to ensure a solid life in retirement."

  • **Private Savings**: Only 52% of workers 55 and older were saving in a 401(k) or IRA. This means that nearly half of older Americans are barreling toward retirement with no personal savings.

    • The median 401(k) account value for an investor age 65 and older is a measly $58,035 (Vanguard).

  • **Pensions**: The median private pension is only $9,376 a year, according to the Pension Rights Center (2017).

    • By 1996, nearly 80 percent of large private-sector employers allowed defined benefit pension plans *(Forbes)*; by 2017 that number has dropped to 20%.

  • **Social Security**: The average Social Security check is $1,422 a month or $17,064 a year *(2018)*.

    • Social Security will only replace about 40% of the average worker's pre-retirement income. Most seniors, however, need roughly double that amount. Current poverty level for a two person household is **$16,910**.
TERMINOLOGY

PENSION

- A sum paid to a person following a retirement from service,
- 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
- Structured typically in the form of a guaranteed life annuity
- ‘Traditional’ DB is based on salary (FAP), creditable service (accrual rate), and age factors
- Pooled Risk

DEFINED CONTRIBUTION PLAN

- Individual ownership, risk & ‘personal’ responsibility
- Benefits are based solely on an account balance
- Singular Risk

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)
- Tax Deferred Earnings (Employer & Employee)
- Tax Advantaged Savings (Individual)
- Private Savings (Individual)

Retirement should be financed by a combination of the above

To achieve this, the employee needs career long earnings deferral and savings

- Retirement experts recommend an 83% wage replacement rate for an equivalent standard of living
- 125% wage replacement rate, if retiree will be without access to employer subsidized health care
MECHANICS

PAYROLL TAXES

Social Security
  • Goal – Poverty Protection & Living Wage Replacement
  • Guaranteed Life Annuity

TAX DEFERRED EARNINGS (PAYROLL)

Traditional Defined Benefit Plan
  • Employer Sponsored
  • Deferred Current Income
  • Income Tax Deferred
  • Pooled Assets and Risk Distribution
  • Dynamic Funding Requirements
  • Goal – Wage Replacement
    • Typically a Guaranteed Life Annuity
MECHANICS

TAX DEFERRED EARNINGS (PAYROLL)

Typical Defined Contribution Plan - 401(k)
- Employer Sponsored
- Deferred Current Income
- Income Tax Deferred
- Defined Contribution Rate
- Self Directed Investments - Risk shifts to the employee
- Ownership/Control
- Goal:
  - Wage Replacement
  - Portability
  - Flexibility - Hardship & Loans
  - Sufficient Rate of Return
- No defined dollar amount or annual benefit structure
  - Available amount is solely based on the account balance
MECHANICS

TAX DEFERRED EARNINGS (PAYROLL)

Tax Deferred Non Qualified Plans: 457 & 403(b)
• Employer Sponsored
• Deferred Current Income
• Income Tax Deferred
• Goal:
  • Wage Replacement - Supplement to a Traditional Pension
  • Competitive rate of return
  • Wealth Accumulation and Inheritance

TAX ADVANTAGED SAVINGS

IRA (Roth & Traditional)
• Income Tax Advantages with Deferred or Waived Tax on Investment Earnings
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 firefighter, 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 $9.3 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. Great Lakes Advisors certifies compliance with the NCPERS Code of Conduct.
DISCLOSURES

Sources:
• Rev. Rul. 2002-90, 2002-2 C.B. 985
• The History of Retirement Benefits: James Tehrani - June 21, 2016
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• Ignites
• CNBC News Bob Pisani @BobPisani Published 8:18 AM ET Mon, 1 April 2019
• Brittany De Lea Published March 21, 2019 Personal Finance FOX Business
• The Federal Register 2019 Poverty Guidelines

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