Should You Take Your Pension Commuted Value?

By Peter Gorham and Nichola Peterson[1]

In our experience, most people who are given a choice of taking their pension or transferring the commuted value to personal locked-in RRSP will take the transfer. It's a large amount of money - maybe larger than anything else you have received before - and it just seems that much money has to be better than a monthly pension income. But is it?

You could always get advice. Most financial advisors are compensated by commissions based on how much money you invest with them, so it is in their best financial interest for you to take the commuted value. Fortunately, not all financial advisors put their personal interests ahead of yours, but it can sometimes be hard to determine whose interest is put first. Compound that with many advisors having little real understanding of workplace pensions and it is easy to receive a recommendation to take the commuted value.

If you are advised to take your pension, you can be fairly certain your advisor has only your best interests at heart. But just because you are advised to take the commuted value does not mean you should distrust your advisor. There are many reasons to prefer a commuted value -- and many to prefer a pension.

***Interest Rates*: -** If you take the commuted value, you are betting that you can earn investment returns *after fees* that on average will be greater than the interest rate used in the calculation of your commuted value. Canadian mutual funds are today charging an average of about 2.4% in fees, so that means if the commuted value was calculated using a 3.0% interest rate, you need to invest to earn an average of about 5.4% return (prior to fees). To earn that level of return, you will need to include a fairly high percentage of equities (stocks) in your investments. With that, you will face possibly large daily, monthly and annual fluctuations in your total investment value. Of course, you could use lower fee funds or even ETFs (Electronically Traded Funds - but only if you know what they are and how they work), but you will still be facing an uphill battle to beat the rate used to calculate your commuted value unless you include equities.

It is different if your pension has indexing (increases based on a percentage of the inflation rate). To do better than the pension amount, you need to earn interest greater than the rate used in the calculation of your commuted value *plus* fees *plus* the indexing rate. (That's because the interest rate shown for indexed pensions is the actual interest rate used minus the expected future rate of indexing. If future inflation is expected to average 2.0% per year and if the interest rate shown for your commuted value is 1.2%, you will need to earn more than 3.2% plus investment fees. If actual future inflation turns out to be less than 2%, you can get away with earning less and if actual inflation is greater than 2%, you will need to earn more.)

If you choose to take the pension, you have eliminated the investment risk – if investment returns do poorly, you will still receive the pension you were promised. However, you have also eliminated

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the upside potential – if investment returns do well, you will still receive the pension you were promised without getting to participate in the extra investment returns.

Investment Knowledge: - How comfortable are you in selecting and monitoring your asset mix? If you take the commuted value, you must also take responsibility for investing it. Also remember that the right asset mix for you will almost certainly change through your retirement years – you will need to review your choices and adjust them from time to time. In addition, you will need to take responsibility for rebalancing your portfolio regularly to bring it back to your chosen asset mix. Financial advisors can help with these decisions - you should meet with your advisor *at least* once a year to review your investments and discuss any potential changes in your profile.

Longevity: - How long will you live and need money? A 60-year-old male currently has a life expectancy of 27 years - to age 87. For a 60-year old female, it's to age 90. That means she has about a 50% chance of celebrating her 90th birthday. She also has a 50% chance of dying before age 90. By taking your money out of the plan, you have to manage it to have enough, even if you live to 100 or beyond. Whatever you do, don't make the classic mistake of planning to need money for only your life expectancy - that would be giving you a 50% chance of running out of money.

If you take the pension, the plan is the one at risk if you live "too long". A pension plan works by using averages. If there are 1,000 pensioners, we know that on average, about 500 of them will die before their life expectancy and about 500 will live longer. The cost of everyone's pension is the amount needed to pay a pension for their life expectancy. Those who die earlier will leave money behind that is about equal to the amount required to pay pensions to those who live beyond their life expectancy.

Your commuted value is essentially the amount required to pay your pension for your life expectancy *and then stop*. By taking your commuted value, you are no longer part of the group of pensioners, and there is nothing left behind by others to keep paying your pension. Conversely, whatever you leave behind can go to your beneficiaries.

With the commuted value, unless you are willing to run out of money in the middle of your retirement, you need to make provision for the possibility of living "too long". This can be done by taking a smaller monthly income than the pension plan would have paid. For example, if you were entitled to $1,000 per month pension, but you took your commuted value, you would likely need to decrease your income to about $750 to $800 per month to give you a good chance of having enough money in case you live past age 95 or 100.

Don't scoff at living that long. With medical and lifestyle improvements, a 60-year old couple (male/female) has a 12% chance that at least one of them will live past 100.

Flexibility vs. Predictability: - If you take the pension, one of the greatest advantages is that you will have a predictable stream of income for the rest of your life. If you take the commuted value, how much can you afford to withdraw each year?

In order to create retirement income from your commuted value, you will need to transfer it to a Life Income Fund (LIF). Once your money is in a LIF, there are annual minimum required withdrawal amounts which increase with each year of age. There is also a maximum limit on how much you can withdraw, which also increases with age. While some find the minimums and maximums too restrictive, this arrangement does provide some flexibility to fit your income stream around your other sources of retirement income.

Need some extra cash as you transition into retirement – perhaps to pay off some last debt or to do some home renovations? When you transfer your money to a LIF, many provinces have a one-time opportunity to unlock a portion of the money and take it in cash (less tax) – Ontario, for example,

allows up to 50% of the amount transferred to be unlocked and paid out. Alternatively, you may choose to unlock 50% and transfer it to a not-locked in vehicle such as your RRSP or a RRIF. This allows extra flexibility – once your money is held in a RRIF, there are annual minimum withdrawal amounts, but no maximums. Having a portion of your retirement savings in a fund that allows unlimited withdrawal can be great in the inevitable year when all of your appliances decide they need replacing!

***Genetics and Stuff**:* - How old were your ancestors when they died? How is your health/nutrition/ lifestyle/weight etc. That can give you an idea whether you are more likely to live longer than average or die younger than average. If you are likely to live longer, then the pension starts to look really good. If shorter, then taking the money now gives you funds to live and a chance of leaving a nice inheritance. But poor genetics and/or poor health does not *guarantee* that you will die young. You will still have to consider longevity and the possibility that you might run out of money if you end up living a long time. And conversely, good genetics and health is no guarantee of a long life.

Spouse: - The same genetic and health questions apply to your spouse. In addition, women on average live 2 to 3 years longer than men. (It used to be 5 to 6 years longer, but the gap has been closing over the recent years). Also, there is usually an age difference between spouses. Even so, either spouse could outlive the other one for a short time or a very long time.

You need to make sure there is enough money available for your spouse's remaining years even if the probabilities suggest that your spouse will be first to die. Unless you and your spouse waive it, the pension plan will automatically continue to pay a pension at least equal to 60% after your death for as long as your spouse (that is, the person who was your spouse on the day you started your pension) survives. If you take the commuted value, you need to make plans for enough money to be left to provide a survivor benefit.

Some couples are lucky and both spouses have a pension that is enough to look after their own needs. If both you and your spouse agree, there may be little need to make provision for your commuted value to have enough to pay a survivor pension after your death.

A New Spouse: - Any surviving spouse benefit from a pension plan is paid only to the spouse as of the date of retirement. If you think you may have a spouse after you retire who is not your spouse on your retirement date, there will be no surviving spouse income paid from a pension but you will have the ability to provide for them out of a commuted value.

Risk: - Are you risk averse or are you willing to take financial risks? If you or your spouse is risk averse, a pension has less risk than the commuted value. You won't have to manage the money, worry when returns are negative, worry about whether you can afford to withdraw money now in case you run out later, etc. If you're comfortable with market fluctuations today, will you feel the same when you're 85? In our experience, it gets harder to ride the roller coaster of investment returns as you get older.

Even so, the pension is not without risk. Unless your pension is fully indexed, you will need to think about managing future inflation – you will also need to do that if you take the commuted value.

If you decide that you want to take the commuted value but also want to reduce the longevity and investment risks, at retirement, you could take a portion of your locked-in RRSP account balance (possibly half) and buy an annuity from an insurance company. The rest you would transfer to a LIF and take monthly or annual withdrawals from it. You have reduced your longevity risk but retained a good fund to help with inflation and provide the ability to vary the amount you live on from year to year. Another great strategy to manage the longevity risk can be to take the lump sum,

but plan to buy an annuity if and when you reach, say, age 75 or 85 – that annuity gets less expensive as you get older!

If you can afford to do so, delaying the start of your Canada Pension Plan ("**CPP**") and/or your Old Age Security ("**OAS**") benefit to age 70 will result in an increase in the amount of the monthly benefit and provide you with a lifetime income guarantee. It may be that guarantee is enough of a safety net so you are not concerned about exhausting your other retirement assets while you are still alive.

Inflation: **-** Inflation is the enemy of retirees on fixed incomes. The only way to remove the inflation risk is if you happen to have a fully indexed pension. Otherwise, you will face the inflation risk whether you take your pension or the commuted value. You can self-manage for inflation by taking a portion of you're the monthly pension and investing it to be used in the future once your expenses exceed your income – or by making sure that you withdraw only the minimum each year from your LIF and/or RRIF.

Your CPP and OAS benefits are fully inflation protected – your benefits will increase in line with inflation every year. That can provide a good base income amount that reduces, but does not eliminate, the inflation risk.

On the flip side, one school of thought is that after an initial period of retirement, your level of spending reduces over time along with your level of activity as you age and the effect of inflation is greatly reduced.

Other Sources of Income: **-** Think about your pension as part of the total income you will have in retirement. If you (and your spouse) already have a large income that is guaranteed for your life, the guarantee from this pension might be relatively unimportant to you. If your only income with a lifetime guarantee is OAS and CPP, the guarantee from this pension might be worth a lot to you.

Employer Bankruptcy: - Taking the monthly pension leaves you with the risk of the pension plan's insolvency should your employer go bankrupt. It's not an all or nothing risk. If there is a bankruptcy, the money in the pension plan is still there to pay all future pensions, but possibly not at the full amount. In Ontario, there is a fund that guarantees the first $1,500 per month of pension will get paid for your life. If your pension is more than $1,500 per month, the portion that exceeds $1,500 could be affected by a reduction based on the funded percent of the plan. In the rest of Canada, your entire pension could be affected by an insolvency.

Severing the Tie: **-** There may be an emotional benefit from removing all connections with your former employer by taking the commuted value. Otherwise you will need to remember to contact them when it's time to start your pension as well as advising them every time your contact information changes.

Consolidation: **-** If you change jobs a few times, you could end up with a number of different pensions. Taking the commuted value allows you to consolidate them in one locked-in RRSP rather than dealing with them separately.

Taxes and Debts: - Your commuted value may be larger than Canada Revenue Agency is willing to allow as a transfer to a locked-in RRSP – if so, your termination statement will indicate the excess amount that must be paid to you in cash (less taxes). If you have unused RRSP contribution room, you can contribute the cash payment to your RRSP and get a tax deduction (that is only useful if you do not expect to be able to contribute the maximum to your RRSP out of any other funds).

If you have a mortgage or debts, you could use the cash payment to pay down (or hopefully pay off) those amounts. That can be as good or almost as good as having the money in your RRSP – but *only*

*if y*ou then take the future reduction in mortgage and loan payments and contribute that to a retirement plan or an investment fund. If you spend that extra money each month on an increased lifestyle, it will actually put you further and further from an affordable retirement. (Maybe you could celebrate by taking the first 2 or 3 months of the extra money for something special, but then direct all future extra funds to retirement savings).

If you don't have any debts, any pension money paid in cash is a negative for your retirement income future – because of the taxes you have to pay immediately plus the loss of future tax sheltering. There is a big advantage if you keep your money tax sheltered as long as possible. Taking your pension avoids the immediate taxes and is equivalent to keeping your money tax sheltered.

Income Splitting: **-** Income paid out of a pension plan is eligible for income splitting at any age - so you can even out the income between you and your spouse. By doing so, you will reduce income taxes. Income from a locked-in RRSP/LIF can only be split after age 65 - so income splitting that money is not as useful if you plan to draw retirement income prior to age 65.

Inheritance: - Taking the commuted value may provide you with the opportunity to leave an inheritance for your heirs and/or favourite charities. That will require you to make sure you do not spend all the commuted value, but it also means there is a fund you can dip into for personal needs (at the expense of your heirs) should you find yourself needing extra money.

You can still leave an inheritance even if you take the pension. When your pension starts, elect a guaranteed period of ten or fifteen years. If you die early, payments after your death go to the inheritance. While you are alive, contribute a portion of each payment to an inheritance fund. With this method, you gradually build up an inheritance fund, whereas with the commuted value you start with a large inheritance fund and gradually draw it down to meet your living expenses.

Medical Benefits: **-** Some employers provide retirees with medical and dental benefits – either for life or up to age 65. Usually they are only available to a retiree who is receiving a pension – taking the commuted value may disentitle you. Medical and dental benefits could be worth thousands of dollars annually depending on the level of claims you will have as a retiree. If you are eligible for retiree benefits, you should think carefully before giving them up. Your commuted value does not include any amount as compensation for the loss of benefits.

Summary

The following chart may help you determine which option is better for you. On each line, put a check-mark in the box that is more important to you. If neither statement is important, leave both boxes empty, and if you feel very strongly about the statement, blacken the entire box. Once you have finished, you will hopefully see which option is the better match for your goals.

Pension vs Commuted Value Chart

	Pension		**Commuted Value**
☐	No need to worry about investments	☐	Need to manage investments to earn more than the commuted value interest rate plus investment fees (MER).
☐	Eliminates longevity risk (chance of living a long time) - guaranteed income for life for both you and your spouse no matter how long you live.	☐	Need to constantly pay attention to longevity risk and ensure there are enough funds remaining. May need to adjust your lifestyle.
☐	Monthly income likely greater than what you can take from the commuted value.	☐	Monthly income likely less than from the pension but might still be enough to meet your desired expenses.
☐	Predictable monthly income, but no flexibility in the amount.	☐	Flexibility in the amount of income to draw.
☐	If you (and your spouse) expect to live a long time (genetics), total amount received may be greater than the commuted value.	☐	If you (and your spouse) do not expect to live a long time (genetics), may provide greater total value than taking the pension.
☐	Spouse pension automatic (unless waived).	☐	Spouse pension dependant on fund value after your death.
☐	No worries about poor investment performance.	☐	Investment performance will affect pension amount – increasing or reducing it.
☐	If pension is indexed, reduces or eliminates inflation risk. If pension is not indexed, and you can save about 25% of each pension payment, can likely provide enough money to protect from inflation. Otherwise, inflation is a risk.	☐	If you can live on the minimum withdrawal amount and are willing to invest a large portion of the total value in equities, can likely provide enough money to protect from inflation. Otherwise, inflation is a risk.
☐	Other guaranteed income sources (e.g. CPP, OAS, other pension) not enough to meet expenses.	☐	Other guaranteed income sources (e.g. CPP, OAS, other pension) enough to meet expenses.
☐	You are exposed to risk of employer bankruptcy and possible reduction in monthly pension.	☐	Eliminates any worries about employer bankruptcy causing loss of pension.
☐	Possible advantage to staying in touch.	☐	You want to sever all ties with employer.
☐	Will need to remember to apply for pension when you're ready to start it.	☐	Consolidates retirement savings from all employers in one place.
☐	Entire pension remains tax sheltered and no tax paid until you receive each pension payment.	☐	Large part of commuted value might be paid in cash and taxes may reduce the value significantly.
☐	No funds available to immediately pay off any large debts – must do so from monthly payments.	☐	If there is a large cash payment included, allows you to reduce or eliminate mortgage and debts.
☐	Splitting of pension income permitted on your taxes regardless of age.	☐	No splitting of income from LIF permitted prior to age 65.
☐	No assets for inheritance unless you save part of each payment - inheritance grows as you age. Or elect a guarantee period and die early.	☐	Provides assets for possible inheritance but the amount is likely to get smaller as you age.
☐	Might be needed to qualify for post-retirement medical and dental benefits.	☐	Might lose any post-retirement medical and dental benefits.