MONTHLY PENSION VS. LUMP SUM COMMUTED VALUE:
WHICH OPTION IS BEST FOR ME?

Introduction

Good news! As part of the many years devoted to your employer, you have accumulated a substantial defined benefit pension. The downside? As you prepare for retirement, you are presented with a document, which outlines multiple, and sometimes confusing, options regarding your pension. Should you leave your pension with your employer and benefit from a monthly, predetermined amount or transfer the lump sum commuted value to the financial institution of your choice? If you choose to benefit from your pension, which option is best for you? Are you leaving money on the table by choosing one versus another? Maybe.

The decision around selecting the best option for you does not need to be a complex one. However, it does require that you dedicate time to analyzing each option and conducting some basic due diligence on your employer and their ability to continue to fund the plan in the future. The first step in this process

entails reviewing the provided document and finding out the date by which you must make your decision. Many pension plans will automatically pay the lifetime pension to a member as a default option when no instructions are received by their deadline. As this is an important and irreversible decision, make sure you do not leave it to last minute.

With the deadline to submit your pension instructions in mind, you are then presented with two tasks:

1. Determine – mathematically – whether it is best to benefit from the monthly pension or to transfer the lump sum commuted value; and
2. Consider other qualitative factors in making that decision. For example, do you find comfort in knowing that you will receive a monthly pension for life? If so, you might value that versus having to invest the commuted value and bear the risk of producing a positive return annually.

The Mathematical Analysis

Although it might sound complicated, the mathematical analysis is actually quite simple. It involves a side-by-side comparison between the annual stream of income you expect to receive from your pension (including indexing if your pension provides for it) versus the annual income you can expect from your investment account after you have transferred the commuted value and invested the funds at a conservative rate of return. The option that provides the highest annual income throughout your retirement is the better option.

For example, Sally Smith is 41 years old and is leaving her employer. She has the option to stay in the pension plan or take the commuted value of $830,647. Her base pension amount is estimated to be $34,957 per year starting at age 60 with a bridge amount payable to age 65 of $2,527 per year (indexed to inflation).

	Client: Sally Smith				No Info.		Additional Locked-in Component (LIRA/LIF)			Total Income (100% Taxable)
Year	Age	Bridge	Pension	SERP	Age	Survivor	Balance	Min. %	Min. $	
2040	59	$632	$8,739	$0	-	$0	$0	3.23%	$0	$9,371
2041	60	$2,581	$35,691	$0	-	$0	$0	3.33%	$0	$38,271
2042	61	$2,635	$36,440	$0	-	$0	$0	3.45%	$0	$39,075
2043	62	$2,690	$37,206	$0	-	$0	$0	3.57%	$0	$39,896
2044	63	$2,747	$37,987	$0	-	$0	$0	3.70%	$0	$40,734
2045	64	$2,103	$38,785	$0	-	$0	$0	3.85%	$0	$40,888
2046	65	$0	$39,599	$0	-	$0	$0	4.00%	$0	$39,599
2047	66	$0	$40,431	$0	-	$0	$0	4.17%	$0	$40,431
2048	67	$0	$41,280	$0	-	$0	$0	4.35%	$0	$41,280
2049	68	$0	$42,147	$0	-	$0	$0	4.55%	$0	$42,147
2050	69	$0	$43,032	$0	-	$0	$0	4.76%	$0	$43,032
2051	70	$0	$43,935	$0	-	$0	$0	5.00%	$0	$43,935
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2072	91	$0	$67,976	$0	-	$0	$0	13.06%	$0	$67,976
2073	92	$0	$69,404	$0	-	$0	$0	14.49%	$0	$69,404
2074	93	$0	$70,861	$0	-	$0	$0	16.34%	$0	$70,861
2075	94	$0	$72,349	$0	-	$0	$0	18.79%	$0	$72,349
2076	95	$0	$0	$0	-	$0	$0	0.00%	$0	$0

The commuted value option allows her to transfer $314,612 to a locked-in retirement account and $516,035 is payable to her as a cash lump sum, which is included as taxable income in the year she receives it. She has $40,000 RRSP room available, which she will use to offset some of her taxable income in that year.

Assuming a net rate of return of four per cent, the mathematical analysis projects that Sally would receive a cumulative amount of approximately $44,000 more in retirement income from taking the commuted value and also have surplus assets remaining at death to leave as an inheritance.

Age(s)	Commuted Value Balance	Max. LIF Withdrawal (100% Taxable)		RRSP/RRIF Balance	Min. RRIF Withdrawal (100% Taxable)		Cash Account (Taxable Capital Gains)		Additional RRIF Income	Total Income	Deficit/ Surplus
		%	$		%	$	Balance	Withdrawal			
59/-	$627,014	6.77%	$42,449	$79,719	0.00%	$0	$440,874	$0	$0	$42,449	$33,078
60/-	$607,948	6.85%	$41,644	$82,908	0.00%	$0	$458,509	$0	$0	$41,644	$3,373
61/-	$588,956	6.94%	$40,874	$86,224	0.00%	$0	$476,850	$0	$0	$40,874	$1,798
62/-	$570,006	7.04%	$40,128	$89,673	0.00%	$0	$495,924	$0	$0	$40,128	$233
63/-	$551,072	7.14%	$39,347	$93,260	3.70%	$3,451	$515,761	$0	$0	$42,797	$2,064
64/-	$532,195	7.26%	$38,637	$93,402	3.85%	$3,596	$536,391	$0	$0	$42,233	$1,345
65/-	$513,300	7.38%	$37,882	$93,398	4.00%	$3,736	$557,847	$0	$0	$41,617	$2,018
66/-	$494,435	7.52%	$37,182	$93,249	4.17%	$3,888	$580,161	$0	$0	$41,070	$639
67/-	$475,544	7.67%	$36,474	$92,935	4.35%	$4,043	$603,367	$763	$0	$41,280	$0
68/-	$456,632	7.83%	$35,754	$92,448	4.55%	$4,206	$626,708	$2,186	$0	$42,147	$0
69/-	$437,713	8.02%	$35,105	$91,771	4.76%	$4,368	$649,503	$3,559	$0	$43,032	$0
70/-	$418,713	8.22%	$34,418	$90,899	5.00%	$4,545	$671,782	$4,972	$0	$43,935	$0
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91/-	$0	100.00%	$0	$41,191	13.06%	$5,379	$891,541	$62,597	$0	$67,976	$0
92/-	$0	100.00%	$0	$37,243	14.49%	$5,397	$862,102	$64,007	$0	$69,404	$0
93/-	$0	100.00%	$0	$33,121	16.34%	$5,412	$830,019	$65,449	$0	$70,861	$0
94/-	$0	100.00%	$0	$28,817	18.79%	$5,415	$795,152	$66,934	$0	$72,349	$0
95/-	$0	0.00%	$0	$24,339	0.00%	$0	$757,347	$0	$0	$0	$0
ACCUMULATED DEFICIT/SURPLUS OVER TIME:											$44,548

A certified financial planner should be able to help you with this analysis.

What Is the Commuted Value of a Pension?

The commuted value of a pension is a single lump sum payment that represents the present value of all future pension payments a member is entitled. This amount is calculated by an actuary and is based on a multitude of factors such as the member's age, years of service, the plan's early retirement provisions and prevailing interest rates. It is important to highlight that there is an inverse relationship between the interest rate used in the calculation and the ultimate size of the commuted value.

For example, in simple terms, $800,000 is needed in order to provide an annual income of $24,000 per year assuming a three per cent interest rate, whereas only $342,857 is needed to provide the same annual income of $24,000 assuming a seven per cent interest rate.

Many factors need to be considered when choosing the best option for your pension. However, if you have reached the optimal age of retirement and you are already leaning towards taking the commuted value, you might want to consider retiring sooner rather than later in an environment of increasing interest rates.

The commuted value of your pension can be used to purchase a life annuity or transferred to a Locked-In Retirement Account (LIRA). Depending on the size of the commuted value of your pension, there might be a limit to the amount you can transfer into the LIRA. This limit is called the Maximum Transfer Value (MTV). Any amounts over the MTV are paid out in cash and subject to tax unless you have sufficient RRSP contribution room to shelter that amount.

Other Qualitative Factors

Additional factors to consider when making your decision include:

- **How healthy are you? - The longer you live, the more valuable a monthly pension.**

  If you are in excellent health and your parents lived well into their 90s, you should strongly consider staying in the pension plan, particularly if your pension is indexed. On the other hand, if you are in poor health and have a shortened life expectancy, taking a lump sum may be more attractive. In addition, when you die, the remaining assets stemming from the commuted value will be passed on to your heirs, whereas pension benefits cease when you (or your spouse) die.

- **How healthy is your pension plan?**

  If your plan is underfunded and your company is struggling financially, taking your money out may be a prudent move. Ask your pension administrator for the last triennial valuation of your pension plan or the current funding ratio.

- **Do you enjoy managing money?**

  Taking a pension offers the convenience of receiving a guaranteed cheque every month while someone else looks after your capital. However, if you withdraw the commuted value of your pension and transfer the funds it into a Locked-In Retirement Account, you will have to manage the investments or delegate this task to an advisor. In either case, you now bear the risk of managing the funds and producing a consistent positive return.

  On the other hand, because interest rates are at historic lows (however, this may not hold true in the near future), commuted values are much higher today than they were in the past. That's because when rates are low, a larger principal is needed to generate the same level of benefits.

- **What is your risk tolerance?**

  If your investment risk tolerance is low and you are inclined to panic when the market declines, you might be better suited to taking a pension.

- **What other assets do you have?**

  If the portfolio stemming from your commuted value fails to achieve the expected returns necessary to fund your retirement goals, do you have the ability to adapt by either reducing the goal and/or funding it using other revenue sources such as drawing on other sources of capital?

The Pros and Cons

	Pension	Commuted Value
Pros	• Guaranteed lifetime income that provides longevity protection; • Benefits can be indexed to inflation; • No investment management decisions or responsibilities; • Full pension split with spouse for income tax purposes.	• Amount subject to portfolio performance; • Investment management; • Possibility of achieving a higher return that will produce higher income; • Flexibility of income withdrawal; • Residual value (if any) to be passed on to the heirs.
Cons	• On death, reduced survivor amount for the spouse, and no residual value upon their demise; • Future pension benefit guarantee is based on the financial stability of the employer. Benefits could be significantly reduced if the pension fund is not properly managed; • No income flexibility (no ability to withdraw lump sum for emergencies, etc.).	• Client manages the portfolio and bears all the investment/market risk; • Risk of drawing more funds than necessary, as capital is available; • Risk of outliving the capital; • Capital might be lost due to taxation of a portion of the commuted value that is over the maximum amount allowed to transfer to a locked-in plan; • Only registered withdrawals can be split with spouse for income tax purposes.

We encourage you to consult with a certified financial planner ahead of making this important and often irreversible decision.

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