

Pensions 101: The importance of understanding your pension

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20 COMMENTS

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I have been involved with the Financial Facelift articles since 2013 and in the financial planning industry since 2000. In my time working on the Financial Facelifts, I have been asked many questions about my calculations and recommendations; but bar none, questions about pension calculations have been the most frequent.

With that in mind, there is no time like the present to give a refresher course on how pensions work, how their value is calculated and why they are so important.

There are two main types of employee pensions in Canada, defined contribution (DC) and defined benefit (DB). Both are important to the financial well-being of their members in retirement, though they both work in different ways.

DC pension plan

The DC pension is more like a registered retirement savings plan (RRSP) in the way it works than what most people would traditionally think of as a pension. In this type of pension typically both employee and employer make contributions to the plan. They are usually based on a percentage of income, up to the contribution limit. These contributions are then invested in underlying investments directed by the employee and vetted by the employer.

How the contributions affect RRSP room is fairly straightforward to understand as well. For every dollar contributed, the employee accumulates a dollar of pension adjustment and thereby their available RRSP room is reduced by a dollar. This is regardless of who makes the contribution. The only difference in the contributions is the employee contributions are eligible for a tax deduction and the employer contributions are not.

The purpose of the pension adjustment is to equalize the retirement savings an employee with a pension can make versus someone who does not have a pension.

On retirement, the employee can transfer the value of the plan to a locked-in retirement account (LIRA), use it to purchase an annuity or a combination of the two. With recent federal budget changes a variable payment life annuity (VPLA) or an advanced life deferred annuity (ALDA) are also options to consider.

The current value of this pension is easily known by taking a look at the value of the underlying investments. What is unknown is what future income this pension will produce. As the name says, it is a defined contribution pension, which means the

contributions to the plan are known, but the retirement income is dependent on the investment returns earned and contributions made.

One of the main benefits of a DC pension is that it forces the employee to make retirement savings. By having it as part of the employment culture, and the savings coming right off of one's pay, it encourages employees to save for their future.

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The other key benefit of the DC pension is the employer contributions to the plan. Each plan is different. Some employers may choose to match employee contributions, some may choose to make contributions regardless and some may combine the two in some fashion. No matter how they do it, the benefit is clear to the employee, it is free money toward their retirement savings.

The DB pension plan

The DB pension is what most people think of when they think of a pension. This type of pension provides a known future income stream to the employee – in other words, a defined benefit to the employee. For this benefit the employer, and sometimes the employee, make contributions to the plan that are invested to provide the future income stream. Depending on the investment performance, this may require more or fewer contributions from the employer.

While the end result – a guaranteed income stream – is easy to understand, getting there is a bit complicated. For starters, the DB pension adjustment is harder to calculate than its DC counterpart. Formulas that determine your future benefit involve such inputs as one's yearly maximum pensionable earnings (YMPE), final average earnings (FAE) and years of service.

To further complicate the DB pension calculation, some pensions have Canada Pension Plan/Old Age Security integration. This is where a bridge payment is made between when the pension commences and age 65 to be later offset by the receipt of CPP and OAS. To note, this integration is not perfect, often being different than the actual CPP and OAS received.

There is also the matter of survivor benefits. If the pensioner is married/common-law, then the pension will pay out a survivor benefit to the spouse upon the death of the pensioner. The automatic selection is typically 60 per cent of the full pension amount, but a higher or lower percentage can be selected. This will raise or lower the actual calculated pension payment based on mortality rates.

So now that we have a base understanding of how the pension gets paid out at retirement, we can discuss the next problem: What is the pension worth today? Unlike the DC pension which has an easily determined value, the DB pension "commuted value," is another matter entirely.

So, how much money is needed today to pay the employee a pension for the remainder of their life? The main factors that can influence this calculation include:

- Age at retirement
- Penalties for early retirement
- Mortality of the pensioner and, if applicable, the spouse
- Current age
- Expected rate of return on the investments (often called the discount rate)
- Pension indexed or not
- Rate of inflation

Change any one of these factors and the commuted value can change drastically. Why is this so important? For a number of reasons.

First, if the employee dies before starting the pension, often the surviving spouse does not receive a survivor pension. Instead they receive the commuted value of the pension eligible to transfer into their RRSP. This happens without tax implications, much like an RRSP rollover on death.

Even if the pensioner does not die but ceases employment with the employer who has the pension plan, then one option is to take the commuted value and transfer it into a LIRA in their name. Depending on the length of service, this is a common outcome versus waiting to take the pension at their normal retirement date.

Finally, at retirement the pensioner can choose to take the commuted value instead of taking the pension. Why would someone do that? I have gone through this exercise with many clients over the years and some of the main reasons for making this choice are:

- Financial flexibility – With pension unlocking rules available in some provinces, the pensioner can access more of their funds earlier or keep them tax-deferred longer. Either way, there is increased choice about how to deal with the asset.
- Limited life span – The commuted value can provide a larger death benefit for the surviving spouse. (With most survivor pension benefits being a percentage of the full pension payable or having to take an actuarially reduced pension to receive 100 per cent survivor benefits, the full commuted value can provide more value than taking the payments at a reduced level.)
- Company/pension concerns – though this is rare and there are some funding guarantees, one only has to look at the collapse of Nortel or, more recently, Sears Canada to see examples of where a DB is not fully secure.

· Increased wealth potential – As I mentioned previously, each pension is different. It is prudent to take a look at what the breakeven rate of return is. In other words, what would the portfolio created from the commuted value have to earn to match the pension payments. If the comparable rate of return is reasonable, the pensioner may consider in their best financial interests to take the lump-sum. This happens more often than you might think.

Regardless of what option is chosen, the benefits of the DB pension are apparent. Most of the savings required and all of investment risk in building the retirement portfolio is the responsibility of the employer. This takes the decision to save for retirement out of the hands of the employee.

The value of the DB pension – especially if indexed to inflation – of a long-standing employee will provide a solid base on which to retire, even if the employee has no other assets. If someone worked 35 years at an employer with a DB plan, they could conceivably replace 70 per cent of their pre-retirement salary if they had a pure 2 per cent pension formula. This would, of course, also drive a substantial commuted value if that option was chosen.

For those of you lucky enough to have a workplace pension plan, understanding how it works is an important first step in financial literacy. They don't teach this in school, though I think they should. Whether it is the more straightforward DC pension or the more complex DB pension, understanding how to maximize the benefits and choose the best options available are important steps on your road to financial independence.

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The DB plan: crunching the numbers

The pension adjustment (PA) for a defined benefit pension is more complicated to calculate than its defined contribution counterpart.

The calculation for the PA equals nine times the value of the benefit earned for the year (2 per cent of final average earnings is the maximum value of the benefit permitted by the government in pension calculations – someone with a 2 per cent pension who works for 35 years would have 70 per cent of their former income in pension) minus \$600.

- For example, if the employee had a 2 per cent pension with a \$100,000 salary, the $PA = 9 \times (\$100,000 \times 2\%) - \$600 = \$17,400$. Note: While the PA will reduce the amount of available RRSP contribution room available, only a portion – the employee's contributions to the pension – is tax deductible.

So, based on this example, the DB plan will reduce this person's RRSP contribution room by \$17,400.

The formula to calculate the future benefit varies as well. Most DB pensions work on a percentage of earnings. Often the earnings are a final or best average of some time period, such as three or five years.

Next, a percentage is applied to the average earnings figure. As stated above, 2 per cent is the maximum per year, though the percentage can be lower than this. Plans may also have tiers of earnings often separated by the average year's maximum pensionable earnings (YMPE) over the final three or five years.

(YMPE is the earnings level set by the government – \$55,900 for 2019 – where an employee maxes out on their CPP contributions. So any income above YMPE does not require a payroll deduction for CPP. It is often used in pension formulas as part of a CPP offset.)

Lastly, are the years of service an employee has in the DB pension. The formula of earnings and percentage is multiplied by the years of service.

- A typical formula for an employee with a salary of \$100,000 and 30 years of service may look like this: (1.4% of Final Average Earnings (FAE) up to YMPE plus 2% of FAE above YMPE) x Years of Service, or
- $(1.4\% \times \$55,900 + 2\% \times 44,100) \times 30 = \$49,938$ for \$100,000 of FAE.

So, in this example, the employee can expect to have a future benefit, or annual income post-retirement, of \$49,938.