Pensions: lump sum or monthly payments?

Retiring employees or employees who otherwise leave their jobs are often faced with a tough decision to make regarding their employee pensions.

In many instances, companies will offer their employees the choice between taking their pension in a lump sum form or taking the pension in the form of a monthly pay-out.

Unfortunately, very little support is given to the employee to help them make this choice and as a result, much stress ensues. This is unfortunate given that the analysis can really be quite simple, if the right tools are used.

The Decision

So, is one better off taking the lump sum payment (if it is offered), or sticking with the monthly pension? While there are qualitative aspects to this question, the only way to truly come up with answer is to crunch some numbers. But before we get into any calculations, lets talk a little bit about what is actually going on here.

An employee's monthly defined benefit pension option is fairly straight forward. The employee's entitlement is based on a formula which takes into account the employee's years of service, his/her average salary amount and some percentage amount (usually between 1% to 2%). This monthly amount is calculated to begin at retirement.

The lump sum option is a little more difficult to understand. Choosing this option means that the monthly pension is forfeited. The intent of the lump sum option is to give the employee what is known as the present value (or commuted value) of the monthly pension amounts that would otherwise be received. The calculation, which is usually made by an actuary, makes assumptions about life expectancy and inflation and uses a discount factor to determine what the lump sum equivalent should be. The lump sum amount is meant to represent the effect of receiving a lifetime worth of pension payments (from retirement to death) all at once.

But the question still remains, should one take the lump sum or the monthly pension?

The Number Crunching

No number crunching is required with regards to the monthly pension. The employee knows what this amount will be. And, since the plan is a defined benefit pension plan, the payment is guaranteed. Therefore, the only way the employee can be prepared to give up this monthly receipt is if the lump sum can provide for a greater pay out. Hence the need for some numbers to be crunched.

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An Example

Mr. X, an Ontario resident with an Ontario regulated pension plan is 55 years old and is five years away from retirement. Due to a downturn in the economy Mr. X is losing his job. His employer has given him a choice. Collect an annual pension of $21,600 beginning at age 60 or receive a lump sum pay out of $200,000 immediately. Assuming a life expectancy of age 90, we need to determine whether the lump sum amount can provide a better annual pension than $21,600 a year.

Since Mr. X would not collect his pension for another 5 years, we will assume that the $200,000 will be left alone and could therefore compound during this time. It is important to note that pension regulations mandate that the money must be transferred to a Locked-In Retirement Account (LIRA). At a 7% rate of return, the lump sum would therefore be worth $280,000. In order for Mr. X to begin withdrawing monthly amounts, the $280,000 must be transferred to either a Life Income Fund (LIF) or a Locked-In Retirement Income Fund (LRIF). Using a LIF calculator (For example in Financial Navigator) will help us determine what the maximum LIF payment would be and how long the funds would last. At a 7% rate of return and assuming a CANSIM rate of 6%, Mr. X's maximum payments would average approximately $20,000 a year till age 80. At age 80, $180,000 would be available to purchase an annuity.

Therefore, the break-even rate of return in this analysis is roughly 7%. If you feel you can achieve a rate of return higher than 7% (given your risk preferences), the lump sum would be a more attractive option. If you are a risk averse investor and are not willing to take on the risks associated with aiming for a return higher than 7%, the pension would be a more attractive option.

Note that the CANSIM rate is a discount factor (which is tied to the prevailing federal government long-term bond rate) which is used to establish LIF maximum payouts.

The Decision is also Qualitative

So the question now becomes whether or not it makes sense for Mr. X to go the route of the lump sum payout? It is at this point that we need to consider the qualitative aspects of either choice.

Pension – Positives

The pension is guaranteed. This is a big positive as far as the "sleep factor" is concerned. The pension may also be indexed which in many cases is the full increase in the Consumer Price Index (CPI). The pension may provide benefits such as medical, dental and term insurance.

Lump Sum – Positives

Lump sum pensions are much more likely to create an estate value. Until age 80, if Mr. X passes away, the LIF becomes unlocked and can therefore be passed on to his beneficiaries. If Mr. X used an LRIF, no annuity is needed to be purchased and so when

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Mr. X passes away (even if it is past age 80), the LRIF becomes unlocked and the remaining balance can be passed on to his beneficiaries. On the other hand, the pension option most likely will not leave an estate value. (The only way a pension would leave an estate value is if there is a 'guarantee period' and Mr. X dies within that 'guarantee period'.)

Conclusion

The decision to take the lump sum value of your pension or the monthly payments can affect your financial security for the rest of your life. It is important to take the time to consider all the important variables, such as rates of return, life expectancy and personal estate planning issues.

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