BARENAKED MONEY PODCAST: EPISODE 17

Pension Plans, Pt. 2 – Commuted Value (Machine generated transcript)

Announcer (00:07):

You're about to get lucky with the bare naked money podcast. The show that gives you the naked truth about personal finance with your hosts, Josh Sheluk and Colin White portfolio managers with WLWP wealth planners, iA private wealth.

Josh (00:25):

Welcome to Barenaked Money. The second in our two part series about defined benefit pension plans. And today we're focusing on the commuted value of your pensions, what that means, how you calculate it and how you evaluate whether this is a good option for you. Colin, can we call it a two-part series at actual series? Or is this something else?

Colin (00:47):

You've obligated us to maybe a third part, which we'll have to make up later, but I'm sure we're up to it. We'll find a way.

Josh (00:52):

Okay. Sounds good. My joke this morning is that I do commute every morning from Burlington to Toronto and back. So I have a very good idea of what a commuting means. So

Colin (01:05):

Yes you do, but we'll try to improve upon that during this blood test. How's that

Josh (01:09):

Right? That's right. So call and why don't you kick it off and just explain what is a commuted value. And one may be available for person, people that have a pension plan

Colin (01:20):

Out of a massive respect for the people that choose to plug into our podcast. I thought important that we maybe lead off with who this might be applicable to, because I'd hate for you guys to get all the way to the end of this, to realize that it's got nothing to do with you and other than the dulcet tones of our voice and got nothing out of the podcast. So a commuted value applies specifically to defined benefit pension plans and not all defined benefit. Pension plans offer committed value at all. Sometimes it's right only the pension docs that this is not an option for you. It doesn't matter what other times there's restrictions it has to be before a certain age, or it's gotta be within that after a certain amount of service. And furthermore, because of what we discussed in the last part, sometimes pension plans close to any committed value transfers because of the funding level of the, or other issues with regards to the pension.

Colin (02:09):

So if you're in the sweet spot and I think most people who clicked on this probably have a commuted value statement somewhere that indicates this is an option to them. If you are leaving their employer typically prior to retirement, which would typically mean prior to age 55, sometimes after you may be offered a commuted value. And I'll just say the very basic is it is a sum of money that is calculated a present value to replace all of the future payments. They feel that they are going to owe you and they give it to you in a lump sum for you to try to do smart things with. And it can be a really big number, can be an exciting number, but is it a good number? It takes a little bit more effort.

Josh (02:55):

Yeah. And it's calculated. So I mentioned the idea of a current value. And so do you arrive at that current value of what the pension is? And it's calculated using something called a discount rate, and this is great, 11 grade 12 math these days. It's not super complicated, but it's not super intuitive. Either. A discount rate is effectively like almost a rate of return that you could get on your money. So it's trying to make equivalent the value of something today, a lump sum today, which a is your commuted value versus a stream of consistent, yearly or monthly payments at some point in the future for a number of years. So when calculating a commuted value again, last time we mentioned that, that these actuaries, these mathematicians who are actually calculating and coming up with some of the numbers here, these actuaries are calculating a commuted value using a discount rate, using some assumptions about retirement and mortality.

Josh (03:54):

Again, here's a, here's our word assumptions, right? So there's a number of assumptions that go into this commuted value calculation and the discount rate that's used. So just very simply, Hey, higher discount rate means a lower commuted value and a lower discount rate means a higher commuted value all else equal. Now, the interesting thing about these discount rates is they're based on bond interest rates. And I think as most of our listeners probably know bonds, interest rates today are just about, at an all time low they're a little bit off those lows today, as we sit here in July of 2021, but not too long ago, within the 12 last 12 months, these interest rates on bonds have been at an all time low. So going back to what I said before all the time, low interest rates means all time, low discount rates, which means all time, high commuted values on your pensions, all else equal.

Josh (04:50):

Now, interestingly, these discount rates that are used to calculate the commuted value have changed somewhat over the last 12 months based on some actuarial standards. So historically before December of 2020, after areas were using a federal bond interest rate to calculate these discount rates. And that's led to some challenges because again, interest rates are at an all-time low. So what they've introduced in December of last year is they've mixed in not only federal bonds, government of Canada bonds for the, these calculations, but also a mixture of provincial bonds, which are slightly higher risk, slightly higher return and corporate bonds, which again are slightly higher risk. It's slightly higher return than that. So important to understand things are changing. These assumptions are changing. So it's a bit of a moving target, but that in a nutshell is how you're going to calculate what a commuted value is. Did I miss any color there calling anything you should

Colin (05:50):

Was always in the detail in my career has taught me that there's idiosyncrasies that can creep into this because as an overlay to beautiful, wonderful, magical calculation by the actuarial standards where it's and you outdid yourself, you out geeked me up by quoting actuarial standard board things in this podcast. I hope our listeners are still here, but you've got union overlays to that. You've got provincial and federal legislation overlays to that. You've got the funding level of the pension and overlays that can affect this calculation. And also the other thing that if you really want to get interesting with this, the next thing that happens, you leave one employer, but from the go for the provincial to the federal government, and then they offer you the equivalent service on the other side. So you've got competing, commuted values that should you're ramming together and coming up with an outcome.

Colin (06:39):

So as definitive, as young buck here was with telling me exactly how the calculation works in real life. At the end of the day, just ask the pension people, what's my number, right? And they'll do all the work. And if you understand the variables a little bit, that'll help you. There can be a timing issue where they're using a number from six months ago or 12 months ago, that is material. So it could, there could be all kinds of things that affect the calculation. And we will never attempt to do that calculation. We will ask you to ask the question to get it from your pension provider, understand that they give it to us, but there's a lot of things that can confuse us. So don't begin to try to calculate this yourself. They just, if I couldn't get anywhere close,

Josh (07:23):

Yeah. Don't go to your advisor no matter who it is. I think maybe some of the more plugged in advisors out there, but don't go to any advisor out there and ask them to calculate your community value. They're not going to be able to go to your pension plan administrator, ask them what your commuted value is. And they'll be able to tell you the dollar value. So calling not only do you get this lump sum payments when you commute your pension, but there can be some tax consequences along the way. So what are you seeing today? When people come to you with commuted values, what are the tax consequences that

Colin (07:54):

They're looking at? It depends on a whole bunch of these, but there's a maximum transfer the chicken dues. So if you decide you're taking a committed value, then there's going to be an amount of that transfer that is eligible for a tax-free rollover to a Lira, locked in a retirement account or Lyft for life income fund. There can be a substantial amount of money exceeding that number that you were eligible to receive that as taxable now. And depending on your situation, it's, you've got a bunch of unused RRSP contribution rule. They may be able to hide some or most or all of it. And therefore it all stays tax deferred. And Bob's your uncle, or you may be in the position where you've been a really good RSP contributor over the years, and you don't have any extra room, but good for you. You already have the money in your RSP.

Colin (08:39):

So you're doing pretty well. We help. But in that case, there's, there's a tax consequence. And I guess this kind of gets into how to decide whether or not a committed Italia makes sense, because what you need to do is if you take the commute adventure, you'd say, okay, here's the amount of money that

would end up in a pot, and then you need, we would do a calculation or take a look at it and say, what rate of return would we need to get on that pool of money after all the taxes are paid in order to get you back into the ballpark of getting the same kind of income that's promised to you in your veteran plan, because that's where the rubber hits the road. And that's what an advisor needs to do for you, is to help you understand what's being sent to you, understand what the tax implications then go away and do a calculation and say, you know what?

Colin (09:24):

We need to get a solid 4% rate of return on this pool of capital in order to put you in the same ballpark, to get the same out of money back out over time. And that's a reasonable number. I've also done that calculation where I was going to have to make 18% a year. If my math tells me, I need to make 18% a year to keep up with what they're promising, you want to venture plan. And it's a fully funded venture plan. I want to say. Yeah, no, you shouldn't count on me for 18%. I'm good fact. I'm really good. I'm not 18% reliable every year. Good. And at that moment, it's a commuted value does not make sense. That tax simplification is something that some people miss because they feel, Hey, this is pension money. This is just gonna roll over. Watch carefully in the documentation. There can, and oftentimes is a taxable portion that needs to be taken into account.

Josh (10:07):

Yep. That 18% must have been back in the early eighties. When you first got your start in this business call on because interest rates haven't been that high in a long time.

Colin (10:15):

Yeah. I know if you asked me how it got there, I could tell you, I don't know what variable, whether they were taking something out of context or something's out of step, but I just knew at the end of the day, plight was way better off taking that pension than anything we could deal with.

Josh (10:28):

That's right. Yeah. So a couple of things you mentioned there that were interesting, I think we're fleshing out a little bit, so you don't get this commuted value, throw it in your pocket and go and buy the shiny new boat that you want. That's not exactly what your commuted value is. Like you said, a portion of this commuted value goes into a Lockton retirement account. That means that one, you take the money out of that locked in account, or that Lira, all of it's going to be taxable for you. And you can't take all of it out at one point in time, the locked-in name of there, that means that you can't withdraw a hundred percent of that pool of money in any given year. It's designed to be a pension or like a pension. So they have a maximum percentage that you could draw out each year.

Josh (11:14):

So there's still some restrictions on that capital for you. And as you said, there's some tax impact potentially from the lump sum that you get. And what we've seen, as I said before, interest rates all the time, low commuted values at an all time high, but the maximum transfer value, this hasn't changed. It's just strictly based off of your age. And it's very simple calculation based off of your age. So you've seen commuted values go up, but you've seen maximum transfer values, transfer value on a deferred basis.

Tax deferred basis stayed the same. So that gap continues to grow, which means the taxable impact is growing as well. Something to be aware of when you're

Colin (11:54):

Thinking of, and not too much confusion here, because frankly this is a confusing topic. You know, trustless comments with regards to the locking in provisions of Locked-in requirement or not withstanding the unlocking events that you can trigger in different jurisdictions at different points in time, they can include things like financial hardship. They can include a small balance unlocking and they can include other things in different provinces. The people's Republic of Nova Scotia has got very stringent rules. Like basically you have to have a doctor's, don't say you're just about to die or to get money out. Other provinces, take on your word that if you're having medical issues sealing, you can unlock money. So Josh is absolutely correct. That is the locked-in retirement account. Those fall under pension legislation. And that does fall under whatever jurisdiction of the pension was when it was funded. And there are very severe limitations on what you can do under most circumstances. But as with all wonderful pension legislation, it comes with a book that's 850 pages long with all kinds of gazintas. So what you get not to tutor on hormones, but that's the stuff you need to take to an advisor to make sure you understand what you're getting into.

Josh (13:01):

Right? So speaking of that Colin what you want to take to the advisor, how do you look at the pros and cons? What are some of the questions that you would ask anybody that brings this 850 page book to you and says, I can't read this. What do I do?

Colin (13:17):

Can I use this to bite my boat? You know, so that's often how it gets framed. Look, I think the very, at a very fundamental level, as I said earlier, what you need to do is at least a quick calculation to say what needs to be the rate of return expectation to come close to giving you the kind of income the pension's going to give you. So that's step one. For me, that's a bad answer. Then you stop right there. Or at least you need to understand that you need to understand that you're giving up something or maybe getting ahead by doing that. Beyond that, for me, I have a bias towards control and flexibility. Uh, when you on a defined benefit pension plan, you've got limited options on how you're taking the money out of and restrictions on how and when that can change to be done.

Colin (13:59):

I don't like that. If, if I can play in a space that doesn't make somebody do that, I think at the end of the day, you can make good choices and get further ahead. Not withstanding the guy that wants to buy the boat, because again, you can cause yourself harm. So if you're going to take this money, I put it in a locked in your retirement account and play the game to see how quick, how much money you can get out and invest it all in Bitcoin and marijuana. You need to leave your money in the pension plan. Just stop, you don't even get to play. Like I'm taking you off the field. I'm putting you back on the bench. You stay there because now that it is enough, you can really screw yourself up. So in having that conversation with the client, part of the professional obligation we have is to, so as this person going to buy a hot air balloon or three, or can we trust them.

Josh (14:49):

Does a hot air baloon have more depreciating value than a boat? I'm not sure.

Colin (14:53):

It's just one of those fanciful things that some people really like - hovercraft, hot air balloons. Just examples of things that people when confronted with a large sum of money. Sometimes they think like that it's the basic math is the basic math one expectation of a return do I need to get to? But the flexibility for me is the whole ball game because I've had clients who've retired and they've moved there, they've done the commuted value. And they started drawing from it for a while, but then they get bored. They decide to go back to work and they go, I don't need all this income set because it's in a lira account. We can shut that off for awhile. Like we can stop taking money out of it. We don't need to keep taking money out of it. Go back to work for another 2, 3, 4, 5 years. We'll let this grow some more.

Colin (15:32):

And then when you do decide to finally retire, we can turn this back on. Those kinds of flexibilities can dramatically improve your after tax money. You get to spend in your lifetime. And that's, I've seen those scenarios play out so much, not with the hot air balloon crowd, but with people who are really practical with it, that really can make a big difference with a little bit of good advice, uh, and all the rest of it. If you get much further, add that way. So I have a bias to flexibility. So I like that the money stays in your family. It's part of your estate. It can go to your spouse or your kids. If you leave it in the pension plan, there can be spousal benefits to it and things like that. But again, the lump sum asset doesn't form part of your estate as it does once you take the commuted value.

Josh (16:19):

Yeah. And in some cases buying that boat or that hot air balloon is really important to somebody and it works within their financial capability. So maybe a commuted value can help you get there. And it's still could make sense. I'm going to punt on the hot air balloon comment but I know we have a lot of clients with boats or a passion for that type of thing, and the commuted value can help you get there. Now I'm going to play devil's advocate a little bit too, to you Colin, because a defined benefit pension plan in a lot of ways is a very risk averse way to advance your retirement plan in a lot of ways, and in not all cases, but in a lot of ways, it is because one, you get this, it is defined right? For the most part, this is a guaranteed.

Josh (17:05):

And I, I use this, this, this word very loosely guaranteed cause in a lot of cases is not truly guaranteed. And we covered that in our last podcast. But in some ways it is, it's a set amount that the pension plan is intending to pay you for the rest of your life. If you plan to live to 125, that's going to be extremely lucrative for you. And no advisor is going to be able to earn a rate of return on the money to compensate for the length of duration that's going to pay out. Also, a lot of them will have some inflation protection on them. So that's one unknown, one variable that you can take out or mitigate through the use of a defined benefit pension. Now, again, you need to look at the defined benefit pension plan specifically because not all of them are guaranteed. Not all of them have inflation

protection on them, but a lot of provincial or federal managed by the government plans do have that level of certainty. Yeah,

Colin (18:05):

No, absolutely. But I think another way of saying the same thing, get you're you're, you're, you're talking about here's the, it takes all of the decision making out of it, you know? Cause as some clients, they just don't want that. So they don't want to have a big sum of money that they feel that they're obligated, that they have to make decisions on. Because again, that's stressful to them. They like the idea, I got a pension, what's a pension. The pension shows up my account every month that I like pensions. There's money in my account every month and I don't have to think about that. And what we're talking about is if you do go the commuted value route, it comes with a lot of options. But the other side of it is it comes with a lot of options.

Colin (18:42):

So if you, and some people don't like that complexity. So again, some of that comes down to choice. I would probably argue that pension seem more guaranteed than they really are. And that's largely because they take a lot of the decision making out of it and you surrender yourself to the system and that's very comfortable for some people to do. And there's not, that's not terrible. It's just knowing who you are as a human being. Cause with all of the advantages, the choice brings that comes a little whole bunch, more that you can choose to do different things with your account that may not be in your best longterm interest. You can actually dig yourself a hole and that can be stressful. Even if you're doing everything right. Some people stress over, they've done everything right. But their brother told them that they should have a blah, blah, blah. Or what about this marijuana thing I really need, I feel, I need to understand this marijuana thing because while I've got a lot of money invested for those people, and again, you asked earlier about the conversation, that's the conversation you have with the client. You're trying to make sure you're not going to shorten somebody's life span with stress by making a choice like this. Yeah,

Josh (19:44):

For sure that, that, that stress thing I think matters to us. And it matters to some people as well, because when you have a commuted value, this is a pool of money that you now need to manage. And you're going to see this pool of money go up and down in value over time. And if you see your pool of money drop 10% and you're going to lose sleep over night over that then maybe commuted value is not the right way to go for you. But as you said, Colin even the best pension is not guaranteed in all senses of the word. So there's a lot of different angles to look at this stuff

Colin (20:18):

Yeah. I think one of the things pensions, so going forward with the only get actuarily valued every two or three years, rather than looking at your statement everyday. Yeah. So it's a whole, it's a different way of, you have to be prepared for all the repercussions of it.

Josh (20:32):

Yeah. Now you mentioned one thing that I think is important to just highlight again, is the estate. So if let's say you and your spouse passed away at age 70, your pension is gone, there is no survivor beyond that. But if you take the commuted value of your pension and you pass away at 70, presumably there's going to be a good chunk of that value left in your Lira, in your RSP, whatever it is, that's going to be an asset that can pass on to your estate, to your beneficiaries, to your children, your grandchildren, something that matters to you. So another consideration to throw into the hat there

Colin (21:12):

Again, sorry. My mind keeps spiraling through the other side of everything you say this like up. So you got something else for the kids to fight over. So , I've been around the block a few times. So it's important to understand the three power comes great responsibility. This is not something to be trifled with and for many people. It's one of the largest financial decisions they'll ever grapple with when they get faced with this. Again, just to circle back, if it's not obvious, talk to a financial advisor about this stuff, don't go try to figure this stuff out on your own. Because again, having done this for three decades, now, I still read the little document and try to figure out if there's a different nuance, because it's always different. And there's a lot to keep your hands on here.

Josh (21:52):

And just to be transparent, I think it's worth saying your financial advisor may have a conflict of interest in this, in that they are incentivized to manage more assets for you. And there may be some incentive for them to recommend commuting the value of your pension. We hope that you have a trustworthy financial advisor. That's always doing what's in your best interest and that's considering your personal circumstances and your, your goals and objectives. But it has to be said, this is just one lens. You don't want to lose sight of this fact.

Colin (22:27):

We've done. Previous podcasts on talking to financial advisors and it's pretty quick to figure it out. If you walk in with your pensions table, with a commuted value and they just pull up the account docs and start, okay, so what's your income like if you're struggling to fill out an account doc at that moment, yeah. Walk back out. That's not what you want. Somebody it's going to take a bit of a conversation as somebody should challenge you as to what do you really want to do? That's one of the times when having a plan and having a planning approach is essential. So again, you walk in with a statement of your pension to ask an opinion and they start filling out an account doc, turn around, walk back out because that's not how you want that to go. You need to have somebody to provide you counsel on an official like that.

Josh (23:09):

Yeah. One other smaller consideration. When thinking about commuting, just circling back to that is when you commute your pension with some organizations you'll sometimes lose, let's say health and dental benefits or some type of extended health care that they're offering to their employees through retirement periods. So that's one also tertiary. Let's call it a consideration to make you want to see what kind of spillover affects the commuting of your, your pension may have,

Colin (23:37):

Those options is come in two sides. So it was very rare occurrence. The employer or the pension plan will still to pay part of the premiums for you. So you end up splitting the premium, which makes it inexpensive. Oftentimes you're paying the full cost of the plan. So they're a little less advantageous to that perspective, but what you do get, even when you're paying the full cost is there's no medical underwriting. So if you're going into retirement and you have significant medical needs, that plan typically will require no medical underwriting in there for maybe disproportionately valued, valuable to you. And Josh is absolutely right. You need to take that into account.

Josh (24:14):

Yeah. So Colin, let me ask you this, having talked about all this you've been doing this longer than I have. Have you seen a higher percentage of people, a higher number of people coming to you with the idea of commuting their pension today? Or has it stayed pretty much consistent over time?

Colin (24:30):

It's I probably say it's happening a bit more because people's careers are a little bit more fluid than they have been. I think the numbers on average time working on a job have dropped in the last 10 years, I would have said that the number of defined benefit pension plans out there hasn't really increased. And people who tend to get into a place where they have a big pension plan are not likely to be as mobile, but yeah, almost as safe to say, we've seen this question come up a little bit over the last few years. And I think coming out of this pandemic, we're going to see it happen quite a bit, because again, there's, there seems to be quite a bit of mobility currently in the workforce, but yeah, I think we're going to see this pickup. Sure. More people are going to bump into this as an option to do.

Josh (25:07):

Yeah. And values are somewhat at an all time high. So that's also attractive to people when they see that it's, there's a bit of sticker shock there for them. When they see holy I've been working for how many years, and that's what my commuted value is, that's pretty awesome. Yup.

Colin (25:22):

It's a big number. It's an intimidating number, but it's, again, it comes with a lot of responsibility. I keep circling back to that because as we have this conversation, I keep thinking like, wow, like this there's enough power for people to actually do themselves some harm. So to really approach this with a lot of caution Alright everybody, classes is adjourned a professor, Josh has exhausted all of the research he did on the actuarial standards for that shared it with you against your will. So, you know, there, there will be a test. And if you're successful with the tests that they could give you some kind of certificate, anyways, this is a very dense subject. And thanks you for sticking with us all the way through the end. Obviously, questions and comments are more than welcome to guide us going forward. So thanks for spending the time with us and the best of luck with your pension. Decision-making thanks for calling

Announcer (26:15):

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Colin (26:54):

Based on observation. It seems that the time and investor is most likely to move his or her portfolio to a new advisor is when the old advisor dies. Let us go on record as saying that having a pulse is not a great reason to trust someone with your entire financial future. Stop putting your life in the hands is still breathing. Wealth planners.com and call us.

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