Pension maximization

Think about it

Introduction

"What's a life insurance policy worth?"

Most of our working clients dream of the freedom of retirement — freedom to travel, freedom to spend time pursuing personal interests and the freedom to live a life of financial security independent from a job.

For many, the transition into retirement is a time of unexpected stress. The change in lifestyle and the disappearance of the work social network can cause anxiety and depression. The pressures can make our clients susceptible to making bad financial choices at a critical time.

For those who are participants in defined benefit or money purchase pension plans, making the right choice between the various pension payout options can mean the difference between a comfortable retirement and one that is financially tight. Financial professionals are often needed to help make sensible decisions.

Married couples, where one spouse is retiring as a participant in a money purchase or defined benefit plan, must choose between getting payments for the lifetime of the participant, or receiving smaller payments for the lifetimes of both spouses. The retiree must grapple with many questions:

- What is the likelihood that the retiring spouse will die first?
- Is the difference between the single life benefit and the joint life benefit enough to justify the risk of choosing the higher benefit?
- What strategies are available to mitigate the risk of choosing a single life benefit?

The pension max concept

Defined benefit plan

A defined benefit plan is a type of pension plan in which the employer promises each eligible employee a specified monthly benefit at retirement. The retirement benefit is defined in that it is based on a formula that is set forth in the plan document.

The formula used might be based on the employee's average earnings, or highest earnings. Generally, the defined benefit retirement benefit begins at a specific age, and is paid until the employee's death.

Defined benefit plans are typically funded only with employer contributions. At retirement, the defined benefit is typically calculated based on the participant being single. However, federal law requires, in the case of a married participant, that the pension be paid in the form of joint and survivor annuity.

Those struggling to answer those questions should consider the possibility of choosing the pension maximization (pension max) strategy. The financial professional needs to be prepared to help decide whether pension max works.

Money purchase plan

Most money purchase plans use a benefit formula requiring an employer contribution that is a flat percentage of each employee's allowable compensation. Percentages up to 25% may be used.

When an employee reaches retirement age, the retirement benefit is payable. Money purchase plans usually provide that the participant's account balance is converted to an annuity at retirement, based on the plan's annuity rates.

A money purchase plan, like a defined benefit plan, must provide a joint and survivor annuity as the automatic form of benefit. The participant, with the consent of the spouse, may elect a different benefit option.

The joint and survivor options

The joint and survivor annuity must provide the survivor a benefit of between 50% and 100% of the initial benefit. It is possible for the participant's spouse agrees to waive the survivor benefit, and the parties can choose the single life benefit instead.

Some plans offer several options for married participants. For example, the pension might give a choice between:

- Single life
- 100% joint and survivor
- 66 2/3% joint and survivor
- 50% joint and survivor

Electing a joint and survivor option protects the participant's spouse and assures an income as long as either spouse survives. The protection does come at a cost — the reduction in income compared to a single life option for as long as both spouses are alive. The size of the reduction depends upon three factors:

1. The age of the parties
2. The percentage of initial benefit preserved for the surviving spouse
3. Whether or not the company sponsoring the plan subsidizes the survivor benefit

How much might a reduction be? For a prospective retiree, the monthly benefit might be $2,000 for life only, as contrasted with $1,700 per month for a joint and 50% survivor annuity, or $1,500/month for a 100% joint and survivor benefit.

Underwritten or Guaranteed Issue life insurance?

It makes intuitive sense that if a plan participant is choosing between a life only benefit and an income stream that will last for two lives, the life only benefit should pay more. What retirees sometimes fail to grasp is that if they choose a joint and survivor benefit, they are essentially buying life insurance coverage on the retiree with the difference between the benefits. Since no medical underwriting is involved, the insurance coverage is guaranteed issue coverage.

What if a healthy retiree could choose fully underwritten life insurance coverage? Could the pension benefits be increased? Those are the key questions in the pension max concept. Pension max is a strategy in which the plan participant elects a life only annuity and uses some part of the additional benefit to purchase a fully underwritten life policy.

Suppose in our joint and 50% survivor example above, adequate protection could be provided to the participant's spouse through purchase of a life policy costing, say, $100 per month. This would give an additional income of $200 per month while still fully protecting the needs of the surviving spouse. That's how a good pension max implementation should work.

What if a joint and survivor benefit is chosen and participant's spouse dies shortly after retirement? Under those circumstances a participant would be "paying" for protection that is no longer needed. A few plans will allow the participant to go back and re-elect life only under these circumstances, but in most cases, the participant is stuck with the smaller monthly benefit for life.

A pension max plan is more flexible than the survivor annuity choice. If the participant's spouse predeceases the participant, the participant could then cancel the insurance and keep the entire extra benefit, or alternatively, keep the insurance and provide a death benefit to the children.

Special concerns

Pension max seems like a pretty simple concept — and it is. The key question is this:

Can the client buy a life policy that will adequately support the surviving spouse using the difference in benefit between the single life retirement income election and the joint and survivor alternative?

There are a few nuances that a client must consider in evaluating the choices.

Role of interest rates, death benefit and survivor's assumed life expectancy

If the pension plan participant dies before the spouse, the pension max strategy relies on the insured's death benefit to replace the spouse's retirement income. There are three ways to make that happen:

- Exchange the death benefit for an immediate annuity based on the surviving spouse's life (annuitization solution).
- Manually create an income stream by investing the death benefit, and using as much income and principal as may be needed for the surviving spouse's benefit (income and principal solution).
- Plan to keep the death benefit principle invested, and use the income earned only to support the surviving spouse's needs (income only solution).

1 All three of the alternatives rely heavily on the assumed interest rate to determine the amount of initial death benefit needed to make pension max work.

2 Here's an example. Say that a client is trying to decide between a $2,000/month single life benefit and a $1,500/month 100% joint and survivor benefit. If the client wants to evaluate the pension max alternative, she needs to figure out how much death benefit is needed to produce $1,500/month, or $18,000 in a year.

3 If the client is comfortable assuming a 5% rate of return on the death benefit invested, the amount of death benefit needed is $360,000. If the client wants to assume a 3% rate of return on investment, the initial death benefit needs to be $600,000.

4 Of the three alternatives, the income only solution will generate a need for a higher death benefit than the other two. That's because the clients intend for the death benefit principal to be preserved for family at the death of the surviving spouse.

5 Finally, if one of the first two solutions is chosen, the survivor's assumed life expectancy plays a key role in determining the death benefit need for the pension max solution. If the survivor's life expectancy is 10 years, less initial death benefit is needed to support retirement income than if the expectancy is, say, 30 years.

Extra pension benefits

Some pension plans add extra benefits that make the pension max calculation a little harder.

For example, some plans include an automatic cost of living adjustment (COLA) for both single life and joint and survivor benefits. Often the COLA amount is adjustable, based on an outside published index. If a client is trying to evaluate pension max, it means that she and her advisor will have to guess at the COLA increases to make a comparison.

Some pension plans require that a joint and survivor option be chosen in order for retiree health benefits to cover a surviving spouse after the participant's death. If that is the case, the cost for continuing such benefits must be accounted for in the pension max calculation.

With all the unknowns, comparing pension max to the joint and survivor annuity is not an exact science. Those working with clients should work with their customers to determine the conservative assumptions that will be used for the pension max discussion. For life professionals, the biggest issue often is timing. Unfortunately, most prospective clients aren't approached with a pension max proposal until shortly before retirement. If the agent waits until shortly before retirement to propose pension max, he or she is faced with writing a new life policy on, say, a 65 year-old male. At that point, the prospect may be uninsurable or insurable only on a rated basis. Even if insurable at standard rates, the premium on a cash value policy adequate to provide the desired protection may kill the deal. Term rates may initially be acceptable but will rise rapidly as the prospect ages.

Contrast this with pension max started 5 or 10 years prior to normal retirement age. The life insurance rates will usually be much lower and the chances of getting a standard or preferred rating much better. The life professional might propose a cash value policy 10 years prior to retirement to be funded over the remaining working years. This plan would provide the spouse with death protection not only after retirement, but prior to retirement also.

At retirement, the cash value of the policy could be sufficient to carry the policy without further premium payments, thus ensuring that the participant can elect a life only pension, receive the higher benefit, and still be assured of death protection for the spouse. The entire increase in pension benefit is available for living expenses without any reduction for life insurance premiums.

If the cash value is high enough, the couple may be able to increase their retirement income even further via policy loans or partial surrenders. If the participant's spouse dies first, the participant has the option of surrendering the policy for its cash value or continuing the policy to provide a death benefit to children or other beneficiaries.

Start early

Pension max cases don't always work. The key question is whether the right amount of insurance can be purchased with the difference in monthly benefit between the life only plan and the joint and survivor plan.

Whether pension max makes economic sense for a particular client depends upon many factors:

- the tax ramifications of taking a higher or lower pension payout,
- whether the plan subsidizes the survivor benefit,
- the interest rate that the client is comfortable using for projections,
- whether the plan has a cost of living adjustment, and
- timing of the pension max decision.

Here are two brief examples

One example describes a good implementation of pension max, and another that shows where it isn't a fit.

How it works

Joe and Pearl are a married couple who are 5 years away from retirement. They have three adult children.

Joe and Pearl are each 60. Joe is a participant in a defined benefit plan at his current employer. Joe has asked his employer for the projected retirement benefits that will be paid by the plan. The employer said that if Joe picks the life only option, he will be entitled to $3,000/month. If he chooses the 100% joint and survivor benefit, he and Pearl will get $2,000/month.

Joe has asked his financial professional to evaluate whether pension max might work for his situation. They discussed the situation and decided that a 3% interest rate is a comfortable assumption. Joe has also asked about the possibility that some benefit from the plan be preserved for his kids, if possible.

Joe's advisor recommends that Joe consider a permanent life plan with guaranteed death benefit with a face amount of $800,000. Assuming Joe's early post-retirement death, the policy will make $800,000 available to Pearl. If the money is invested and it earns 3% interest, it will generate $2000/month for Pearl — exactly equal to the joint and survivor benefit.

Pearl would also have access to the policy's death benefit to supplement her needs during lifetime. If Joe's pension has automatic COLAs, the death benefit principal would be available for Pearl to help offset that. Any amount left at her death would be available for their children.

If Pearl dies before Joe, Joe can surrender the policy and get the life only pension amount. Or he can choose to continue the policy and increase his kids' inheritance.

Because Joe is in good health, he can buy the insurance coverage for $750/month. Even though the premiums begin pre-retirement, the flexibility that the plan offers — as well as the enhanced benefit for himself and Pearl beginning at retirement — may make it attractive.

How it does NOT work

Take the example above, but assume it's 5 years later. Joe is at his retirement date. The pension numbers are identical to those projected at Joe's age 60.

Say that in addition to being older, Joe has had a medical episode that will substantially increase the cost of guaranteed permanent insurance coverage. Even if he uses all of the $1,000/month difference between the life only and joint and survivor benefit, he can only buy $300,000 of death benefit.

Does it make sense for Joe and Pearl to choose pension max?

Say that Joe uses all the $1,000/month difference for life insurance. If he does that, he has no cushion for COLA that he might otherwise have been entitled to.

If Joe dies, say, 5 years after getting started, the policy would pay its $300,000 death benefit to Pearl. Assuming Pearl continues to enjoy good health, her life expectancy might be 20 years after that. If Pearl annuitizes the $300,000 death benefit based on her life expectancy and a 3% assumed interest rate, the monthly payment would be $1,658. That's less than the pension's joint and survivor option.

Under these circumstances based on the assumptions given, Joe and Pearl should probably decide NOT to do pension max.

Conclusion

At its core, pension max is a simple idea. The client chooses a life only pension benefit, and uses the extra monthly benefit to buy a life policy designed to protect the surviving spouse.

Pension max is not a fit for every situation. It works best where

- the percentage difference between the life only benefit and joint and survivor benefit is high,
- the non-participant spouse has a short life expectancy compared to the participant spouse,
- there are no valuable benefits that an employer provides that hinge on choosing the joint and survivor benefit, and
- the participant spouse is healthy and insurable at a reasonable price.

Even if pension max is not a fit, financial professionals may be able to help supplement their clients' retirements with other tools. If you start talking with clients early in their retirement planning process, you can help maximize their retirement income potential — and help yourself along the way.

For more information, please call the Life Insurance Sales Desk or visit equitableLIFT.com.

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