Annuity Ins and Outs

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A previous *MoneySaver* article on annuities (September 2002) outlined some of the situations for which it made good sense to employ them. They are particularly helpful in estate planning, where they can be used instead of more complex trusts for smaller amounts of money. This article focuses on annuity purchases at retirement.

The most common type of an annuity by far is what we call a pension. During our working lives we accumulate a sum of money and at retirement it can be converted to a life annuity to pay us and our surviving spouse a monthly income until death. For many employees, the annuity purchase is mandatory. For others, a decision must be made whether to take the pension arrangement offered or to take affairs into their own hands by transferring the assets out to a private administrator, allowing for more flexibility in structuring pension income and in maximizing estate value. By opting for personal management of their pension assets, they place themselves in a similar situation to those who have RRSPs or RRIFs.

In all cases, however, it pays to know in advance what the questions are that will be asked when annuity time rolls around. Whether we choose a company pension, do it ourselves with locked-in retirement account (LIRA) pension funds transferred from an employer, or convert all or part of our RRSP or RRIF to an annuity, certain basic options must be considered. Each has its pros and cons and usually involves an increase or decrease in monthly benefit payments.

As a "base example" for the purposes of comparison only, I have utilized the price quotations of a large insurer for a married couple, both aged 65, purchasing a $350,000 joint annuity. They have selected as initial options a 60% survivor benefit, a 15-year guarantee and no indexing. This will initially yield them a life income of about $24,000 annually or $2,000 per month.

Joint or single: Joint and last survivor annuities for married couples are mandated by law for locked-in company pension plans. If the primary annuitant dies, the surviving spouse is entitled to at least 50% of the pension payments. However, the spouse can waive this survivor benefit so that the annuitant receives a higher monthly payout. Or, the terms of the pension can be adjusted so that there will be a greater percentage payout than 50% to the spouse in the event of their partner's death, at the cost of a lower monthly payment.

In my experience, it is not a good idea for a spouse to waive survivor rights. The premature death of the annuitant can leave the partner with no pension income for one or two decades. For annuities bought with personal RRSP or RRIF money where there are no rules concerning survivorship, joint annuities likewise make sense. The increased monthly benefit, where no right of survivorship is selected, is not great. Using the base example above, a change from a 60% to a 0% survivor benefit would mean that the annual pension amount would increase by $2,000 (to about $26,000 annually). On the other hand, going from a 60% to 100% survivor benefit would mean an annual decrease in payments of only $1,000 (to $23,000 annually).

Length of guarantee: Many plans have an option that permits an annuitant to choose the number of years that the monthly benefit (or equivalent discounted lump sum) will be paid, even if they and their survivor are not alive to collect it. Opting for a guarantee seems prudent to me. In most cases the annual cost of a 10-year guarantee is minimal, and it could mean a lot to your heirs should there be premature deaths.

Having no guarantee at all increases the $24,000 annual benefit of the base example by only $56 per year over an annuity with a 5-year guarantee, by $329 over an annuity with a 10-year guarantee and by $929 (to about $25,000) over the base 15-year plan.

Indexed or not: The "cost" of annual indexing that covers inflationary increases is that the pension benefit is reduced during the first 10 years or so of payments to less than it would be were there no indexing. After that, the benefit reaches and then exceeds what the non-indexed pension's "level" benefit would have been. For those who live a long life, indexing is a great advantage because it helps to preserve buying power. In my opinion, a 2% annual increase would be sufficient in most cases to provide a reasonable benefit over the life of the plan. (A word of warning: check the provisions of company pension plans that claim to provide cost of living protection. Sometimes the increases are not credited unless the Consumer Price Index surpasses a threshold of 2 or 3%, something that may not occur every year.)

In terms of our base example, the initial annual benefit amount when the annuity features 2% annual indexing is $4,500 lower than the base example annual payment of $24,000 (that is, $19,500 per year or $1,600 monthly). The annual benefit increases by 2% compounded each year after the first year, reaching the $24,000 mark in a little over 10 years and continuing to increase from there.

Up to this point the decisions to be made about an annuity purchase, while important, have been fairly straightforward. With the help of an advisor and several weeks of pondering, it's not too onerous a process to undergo. But the situation can become more complex when the pension assets are in an RRSP or when they have been transferred to a private administrator from the administrator of the company plan. Such a transfer may be done because private annuities offer higher payouts than the company plan. (I find it surprising that as an independent broker I can often match or surpass company pension quotations.) The company plan may not offer certain desired features such as indexing, or you may discover that the company is backing the pension plan itself rather than employing an outside insurer to do so. Relying on an outside insurer is much more secure, as the failures of several large American corporations and the resulting adverse effect on their pension plans have recently demonstrated. Of more significance perhaps to *MoneySaver* members, for those interested in managing their personal finances to their best advantage, company plans are notoriously inflexible.

By taking our retirement savings away from the company plan in which they were accumulated, the "commuted" or discounted value can be transferred to a locked-in plan, or LIRA. In some instances, this decision must be decided before age 55. As is the case for RRSPs and RRIFs, more decisions must be made (and somewhat more risk taken) when a transfer is affected. With a LIRA, RRSP or RRIF, pension money can be invested in a combination of annuities and other investments, and drawn upon when we have need. For example, if the commuted value transfer is made at age 65, the LIRA, like an RRSP, need not be drawn upon at all until age 70 when LIF or RRIF withdrawals become mandatory. Personal RRSP plans (which, unlike locked-in plans, have no maximums on withdrawals) and non-registered savings can be employed during the years before age 70, keeping unneeded pension income, which is fully taxable, out of a higher tax bracket and in some cases avoiding the dreaded clawback of OAS benefits.

If a minimum guaranteed pension income is desired so as not to be left entirely at the mercy of the stock and bond markets, only the portion of the LIRA necessary to fund that need can be used to purchase an annuity. The remaining capital can be left invested and passed on through the estate to one's heirs—something that would not be possible if the full pension amount were used to buy an annuity. Personal management of one's pension money also allows for annuities to be purchased over a period of years to take advantage of interest rate increases should they occur. Because the payout of annuities is based on long-term bond rates, increased rates mean greater benefit amounts (in addition to higher benefits received as one grows older). A "staggered" purchase strategy of this kind is also advocated by *MoneySaver* writer Jim Otar (December 2002) as a means to ensure that pension assets are not prematurely depleted.

The baby-boom generation is rapidly approaching its retirement years, meaning that annuity decisions cannot be escaped. But as with many other things, knowledge and planning will go a long way to ensuring that the financial needs of retirement will be met.

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