Retirement: What If My Pension Plan Payout Changes?

Can My Pension Plan Payout Change?

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You have been employed for a period of time and you have access to a pension plan from your company. Can what you receive change from the time you commence working to the time of your retirement? It sure can. When you enroll in a pension plan, you are expecting a certain payout each month when you retire. If the payout is larger, that is wonderful, but what if it is less? If you are counting on living from this money, what can you do? The payout you receive can be defined by several components, so each of these will be highlighted. The first thing to find out is what type of plan you have and what you are entitled to.

What Type of Plan Do I Have?

There are two main types of pension plans as defined below. Some people may have both types of plans or a mixture of the two from different employers. If you had a pension plan with an employer and then transferred the money out into your own locked in account, this article would not apply in that case. You would be generating your own income and payments from your own investment returns, and this is a different set of circumstances.

Defined Benefit and Defined Contribution Plans Defined

A **defined benefit plan** is a pension plan where the future payout in retirement is defined by a set formula when you join the company. It is a calculation that usually includes your highest average salary, time working in the company, and how much money was contributed by you and the employer. The money is invested on your behalf and the firm is responsible for risk if something goes wrong. There is usually an implied rate of return that is guaranteed by your employer each year, which is the investment rate of return your money would earn if you could see your pension plan in a bank account.

A **defined contribution plan** is where the money you pay into the plan is defined: the amount contributed either by you or on your behalf by the company. It is a set dollar amount based on your salary in the year that you are working. You can think of it as the company (and sometimes you and the company) contributing to your pension account. This is similar to a Registered Retirement Savings Plan (RRSP) account, except that it is locked in. Locked in means that the money is in your name and you are entitled to the money, but cannot withdraw it unless there is a very exceptional circumstance (i.e. this is the only money I have and I need to pay my bills). Also like an RRSP Account, you get to choose the investments in the defined contribution scenario, and you are taking the risks. If you invest in a fund and it loses money, you must deal with the consequences. It is for this reason that it is good to have a plan. If you are in a situation where you have a defined contribution account, you will have to make the decisions.

What Features Do I Have in My Plan?

Health Benefits

Many defined benefit pension plans have a provision for health insurance in retirement. This tends to come automatically with the pension money that is paid out. What is covered under this health insurance? What are the limits of what is covered? Is there a deductible or fee that should be paid each year? These fees come from your pocket, so they will reduce the amount of money that you are actually receiving for the health benefits. Can these requirements change over time? Definitely. Since pension plans are a long term idea, even small changes in coverage or higher deductibles can mean more expenses over time. There are instances when certain procedures are no longer covered, or the allowable amounts that can be claimed are reduced. These changes tend not to be very large, but taken as a whole over time they can add up to a lot of unforeseen expenses. Since health benefits are becoming very expensive no matter who pays for them; expect this to be an issue for years to come.

Indexing To Inflation

When most pension calculations are done, it is assumed that there is no inflation in the numbers. If you see the term **"real rate of return",** this interest rate would include inflation, and would equal the **nominal rate of return**, or typical interest rate that is quoted, minus the inflation rate. As an example, if you received a 5% return on an investment last year, and the inflation rate was 2%, your real rate of return would be 5%-2% or 3%. Why does this matter? Typically pension payments are fixed – once a payment is calculated upon reaching retirement, it stays the same throughout retirement. The problem is that when you retire, you are supposed to have enough money to pay for your expenses with this pension payout. If the rate of inflation rises 2% every year up to your retirement, this is like saying you can buy 2% less stuff every year. If the promised pension payment is $2000 per month today, and you retire in 20 years, this 2% inflation rate would reduce the amount of stuff you can buy by 40% (2% x 20 years). If this continues while you are retired, say another 20 years, this money will now buy 80% less stuff than today. Imagine paying bills with 80% less money! **Indexing** raises the payout calculations by the amount of the inflation rate to prevent this erosion of monetary value from happening. Inflation is actually a very personal thing – the price increases of the stuff you personally spend your money on, is what will impact you the most. The pension plans assume that you buy the same quantity of stuff and in the same proportions as the average or quoted inflation rate. This is likely not true, but it is better than no indexing at all.

Another thing to keep in mind is what level the indexing goes up to. Some plans will cap the indexing at a certain level each year to prevent explosive costs. Should there be a year of high inflation, this may cost you as your payment would not keep up with the cost of living for any amount above this cap. This has not been an issue for the last 20 years, but should inflation rise quickly, this should be watched closely. Check with your employer for the calculation to verify.

How Long Do My Pension Payments Last?

Some pension plans will pay you until you pass on, and will then pay your spouse your payment until they pass on. Other plans will pay for a certain amount of years to contain the length of time of their expenses. This is something that should be inquired about, and if there is a set age where the pension benefits expire, this should be incorporated into your financial plan so that you have some kind of income to replace the lost pension income at that time. In many cases, you will not reach the stipulated age, but since lifespans have been increasing lately, and these pension plans were designed decades ago – this issue is bound to pop up eventually. Many plans are struggling with funding issues and longevity risk of their members – which means that pension plans are not getting as much return as they used to get and underestimated how long people are living and receiving pension payments. The longer the pensioner lives, the more money the pension plan has to pay and the higher the longevity risk. The person receiving money living longer is not viewed in a favourable light by plan sponsors as it means your payments will cost them more. The amount of time the payouts will last can also be changed at any time.

What If I Separate or Divorce?

Many plans have provisions for making payments if you separate, divorce or your spouse dies. Over time, these provisions can be changed to not include these types of situations. Lack of coverage can also occur after so many years of service, a certain amount of time being married or under certain conditions of a separation. It is time to get your know your pension plan intimately in these cases so you can prepare for what to expect. In the case of a separation or divorce, splitting the value of a pension plan among spouses is a complex calculation, and it may hold up a divorce settlement that would otherwise have been simple. If calculations of the asset value are approximated, one of the spouses may feel as if they are not treated fairly, and this may lead to a longer battle in court which will be costly in other ways. If you have a financial plan counting on the value of a pension plan as part of your retirement scenario and it becomes known that you will not be receiving this money due to changes in the pension plan rules, this may not be pleasant either.

What If I Am Laid Off Before Retirement?

If you are laid off or reorganized as an individual, there likely will not be many issues with pension plan changes. If there is a company-wide layoff affecting many employees, the pension should be examined for special provisions due to attrition or reorganization. If the company is winding up or going bankrupt, this is another situation where everything should be examined before signoff. Obtaining legal counsel and/or a pension specialist may be useful to make sure the termination contract is in your best interest.

What Can I Do About These Changes?

Most of the time, these changes are inevitable because pension plans will claim that they don't have the money to sustain the gold plated promises of the past. This may or may not be true, but it does not affect your strategy. The first thing to do is to be aware of any such changes. Be aware of which ones apply to you. Sometimes the changes are in effect depending on what year you joined the pension plan, what age you are, how many years of service you have or what seniority you have. If you see a change that is affecting you, explore what can be done about it. Take your current financial budget or financial plan and adjust the numbers for the change to see what the final result is. Not all changes will result in a worse situation for you, but it doesn't hurt to find out. Your pension plan should be reviewed every so often – either after each union contract negotiation or with each annual report or budget. Changes occur slowly with pension plans – but checking frequently is a precaution to keep you aware.

If the change is happening to a large number of people and you have enough people and a strategy to fight the change, it may be worth it to band together and lobby to have the plan sponsor reverse the changes. In many cases, these battles are expensive and time consuming. If you are aware of a change that is affecting you and there is nothing you can do to revise it, make changes in your financial plan to account for it. This may mean leaving the job sooner, planning retirement under different terms like attrition, or putting more money aside for higher expenses. In other cases, the changes may not be a big deal and you can just move on with your life – but you will not be surprised when your payouts are not what you expected in the past.

Much of the information regarding any changes is with the plan sponsor or pension plan administrator. If you are in a unionized environment, talk to your steward about the pension plan and try to find documentation to clarify exactly what the current state of your pension plan is. The Human Resources department is another good place to ask questions, particularly in a non-unionized environment. Lastly, keep the documents you receive form the plan sponsor so that you will actually have in writing what is changing if anything. This will keep the facts straight for you and minimize miscommunication.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**