Unique retirement planning strategies needed for defined-benefit pension plan members

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For people who have a defined-benefit (DB) pension plan through their employers, years of compulsory saving may eliminate much of the uncertainty around how much to set aside for retirement. But these pension plans are only part of an overall financial picture and can be subject to change, underscoring the need for financial advisors to prepare their clients for all possibilities.

According to recent data from Statistics Canada, DB plans accounted for two-thirds of registered pension plans in 2017. Most are held by government employees; as of Jan. 1, 2018, more than 4.2-million Canadians held DB plans, including more than three-million public-sector employees and 1.2-million private-sector workers.

Although advisors and their clients should not be that concerned about the adequacy and solvency of public DB pension plans, a few private-sector DB pension plans have been in focus in recent years after high-profile insolvencies left employee pensions underfunded and up in the air.

"If it's a public pension plan, well, we know we don't really have to worry," says Shelley Johnston, a senior wealth advisor and certified financial planner (CFP) in Whitby, Ont., with the Pension Specialists, which operates under the IPC Securities Corp. umbrella. However, she points to situations such as Nortel Networks Corp. or Sears Canada Inc. – which filed for bankruptcy, leaving underfunded DB pension plans that resulted in pensioners seeing their pensions reduced substantially – as a cause for worry.

Ultimately, every pension plan is different, so helping clients understand the individual nuances of their DB plan is key for advisors, says Ms. Johnston, who is currently running education sessions for General Motors of Canada Co. (GM) employees affected by the pending closure of the company's assembly plant in Oshawa, Ont. later this year – including those who will be retiring with DB plans and those being laid off but not yet eligible to retire.

Factors such as the employer's stability and what the survivor and bridge benefits look like need to be explored with clients, as well as the question of whether the pension is indexed for inflation, which is one of the top considerations in the retirement planning process.

Although most public-sector pensions are indexed to inflation, there is a higher likelihood with private-sector DB pension plans that the cost of living increase is no longer built in, as is the case with GM's pension plan, as Ms. Johnston notes.

"I try to help our clients understand what happens if the pension plan has no indexing, because especially with GM, a lot of these guys are like 50, 55 [years old] and fast-forward 30 years – what's the value of that pension going to be in the way of purchasing power?" says Ms. Johnston.

In general, figuring out the retirement income needs for someone with a DB pension is not much different from any other client. You need to look at their desired lifestyle in retirement and their "financial life map," says Ms. Johnston – including assets, liabilities and factors such as divorce or children in university.

"The defined benefit just makes it easier to calculate for a bigger portion of that [retirement income] – [and the Canada Pension Plan], Old Age Security and the pension are also easy to calculate," says Clay Gillespie, managing director, financial advisor and portfolio manager at RGF Integrated Wealth Management Ltd. in Vancouver.

Still, a client's DB pension plan is ultimately just one "leg of the stool," says Janet Gray, a CFP with Money Coaches Canada in Ottawa – and whether it will be enough depends on how close someone is "living to the edge" before retirement. Deeply ingrained overspending habits may be difficult to overcome, she says, which can lead people to create more debt in retirement when they're living on a percentage of their previous income.

"If the other things aren't well looked after and if [the clients'] lifestyle is more than [they] can afford, then that one leg may not do it," says Ms. Gray.

Thus, helping clients manage their financial situation and plan for retirement depends on their unique circumstances and the details of the pension plan. For example, for clients who have a DB pension that's indexed to inflation, the focus during the pre-retirement years should be on repaying any debt and topping up contributions to their tax-free savings account rather than their registered retirement savings plan (RRSP), says Ms. Johnston.

For clients with DB pensions that are not indexed, the conversation should focus on ensuring they save enough to get to the desired level of replacement income.

"If that defined-benefit plan has no indexing, well, then we're going to need to make sure we have an RRSP set up to help with the latter part of the retirement because of the [loss of the pension plan's] purchasing power," Ms. Johnston says.

Still, nothing is set in stone and advisors and their clients should prepare for the worst. Ms. Johnston cautions that DB pension plans – even those in the public sector – can be subject to change. Last year, for example, Ontario Municipal Employees Retirement System proposed to replace guaranteed indexing with "conditional indexing" when the plan is financially healthy for service earned after 2021 – although the change was ultimately rejected.

"If we find out that, all of a sudden, you're losing the indexing off of your pension, well, you know what, what is that actually going to mean in dollar amounts down the road? We need to start saving for that," she says.

Meanwhile, for those who are leaving a job that has a DB pension plan in place, the discussion between clients and their advisors needs to focus on whether to take the commuted value or remain in the plan.

As a rule of thumb, says Mr. Gillespie, transferring the commuted value of a DB pension is better suited for those who are younger.

“The closer you are to retirement, the more it makes sense to stay in the defined-benefit plan. And that’s not in every case, but you have to prove otherwise,” he adds.

Generally, those who take the commuted value are either moving it to a locked-in retirement account (LIRA) or, in some cases, transferring it to another pension plan, Mr. Gillespie notes. For those approaching retirement, options include a life income fund (LIF) or purchasing a life annuity.

An additional consideration, Mr. Gillespie says, is that individuals who have been in a DB pension plan for a longer period of time and are considering transferring the commuted value to a LIRA or LIF may have a large portion that’s taxable as income in the year of the transfer as there’s a maximum transfer value in the Income Tax Act.

Ultimately, employees also need to consider the question of their DB pension plan’s solvency when deciding whether they should stay in the plan when they leave the company.

“That’s one of the reasons we sometimes recommend people take money out of a defined-benefit [pension plan] even though the numbers look like they should stay,” says Mr. Gillespie. “The solvency of the underlying company is in question and the pension may not be fully funded. We saw the perfect example with Nortel. Just because they promised it to you doesn’t mean you’re going to get it.”