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You're Getting a Pension: What are Your Options?

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Abstract

[Excerpt] For those workers who participate in a traditional pension plan—15 percent of private sector workers and 75 percent State and local government workers—the math exercise doesn't end once you figure out your monthly benefit (often based on earnings and years of service). No matter how the plan calculates your benefit, retirees must have the opportunity to receive periodic payments for life and may be offered alternative forms of payment.

Sound confusing? It gets worse. To really understand the options, you need to remember those "time value of money" calculations if you've ever taken a finance class. In a nutshell, the plan is required to have sufficient assets to be able to pay you the required benefits for your lifetime. The various forms of payment in most cases simply distribute those funds differently. In its simplest form, a plan might have $200,000 in assets designated for your pension. You might be offered a lump sum of $200,000 or monthly payments of $1,050 for life. It may not seem like it, but these two payments are equivalent. Investing $200,000 at 4 percent interest provides a $1,050 monthly payment for about 25 years.

Because the options are designed to be roughly equivalent (more formally, the "actuarial equivalent"), your decision to choose one form of payment over another is not about the monetary value; other factors come into play, such as the need to provide benefits for survivors. This issue of Beyond the Numbers looks at the various payment options and what factors you need to take into account when making a decision. The accompanying charts provide a visual representation of different payment options.

Keywords

pension, payment options, assets, benefits

Comments

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PAY AND BENEFITS

You’re getting a pension: What are your payment options?

By William J. Wiatrowski

For those workers who participate in a traditional pension plan—15 percent of private sector workers and 75 percent State and local government workers—the math exercise doesn’t end once you figure out your monthly benefit (often based on earnings and years of service). No matter how the plan calculates your benefit, retirees must have the opportunity to receive periodic payments for life and may be offered alternative forms of payment.

Sound confusing? It gets worse. To really understand the options, you need to remember those “time value of money” calculations if you’ve ever taken a finance class. In a nutshell, the plan is required to have sufficient assets to be able to pay you the required benefits for your lifetime. The various forms of payment in most cases simply distribute those funds differently. In its simplest form, a plan might have $200,000 in assets designated for your pension. You might be offered a lump sum of $200,000 or monthly payments of $1,050 for life. It may not seem like it, but these two payments are equivalent. Investing $200,000 at 4 percent interest provides a $1,050 monthly payment for about 25 years.

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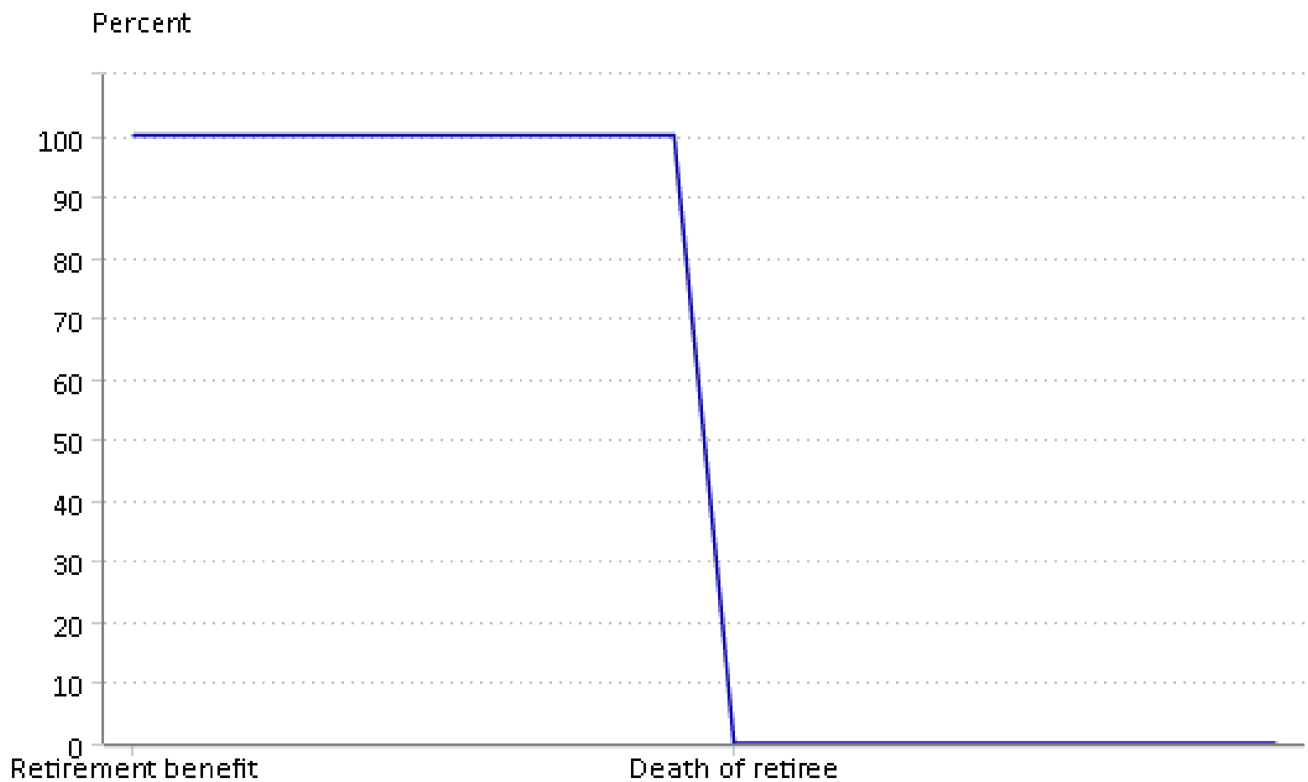
Required forms of payment

Because pension plans are intended to provide periodic payments for life, certain forms of payment are required by law. For single employees, the required form of payment is a *straight-life annuity*, which typically provides a monthly payment based on the plan formula. If the formula provides $30 per month for each year of service, the single employee with 40 years of service would receive $1,200 per month ($30 X 40 years). This value is the starting point for all pension calculations. Chart 1 shows this simplest form of payment a retiree receives based on the plan formula. No adjustments are made to the pension amount and no benefit is available after the retiree dies.

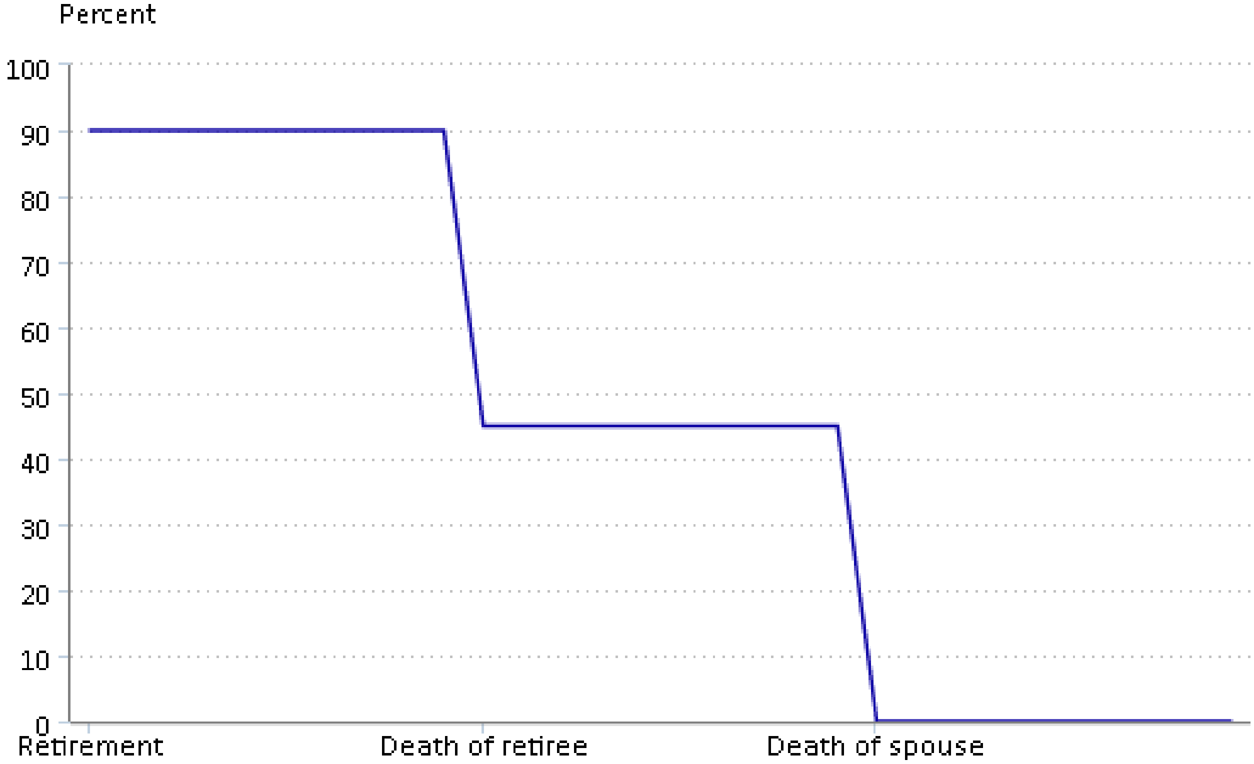
Chart 1. Straight-life annuity: percent of straight-life annuity



Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

For married employees, the required form of payment is a *50-percent joint-and-survivor annuity* designed to provide a “joint” benefit while both the retiree and spouse are alive and half of that amount (the 50-percent “survivor” annuity) to the spouse upon the death of the retiree. (See chart 2.) To offset the cost of the survivor benefit, the straight-life annuity benefit is reduced. The reduction is based on the age of the retiree and spouse. Over their two lifespans, the benefit is designed to be equivalent to the straight-life annuity.

Chart 2. Fifty percent joint-and-survivor annuity: percent of straight-life annuity



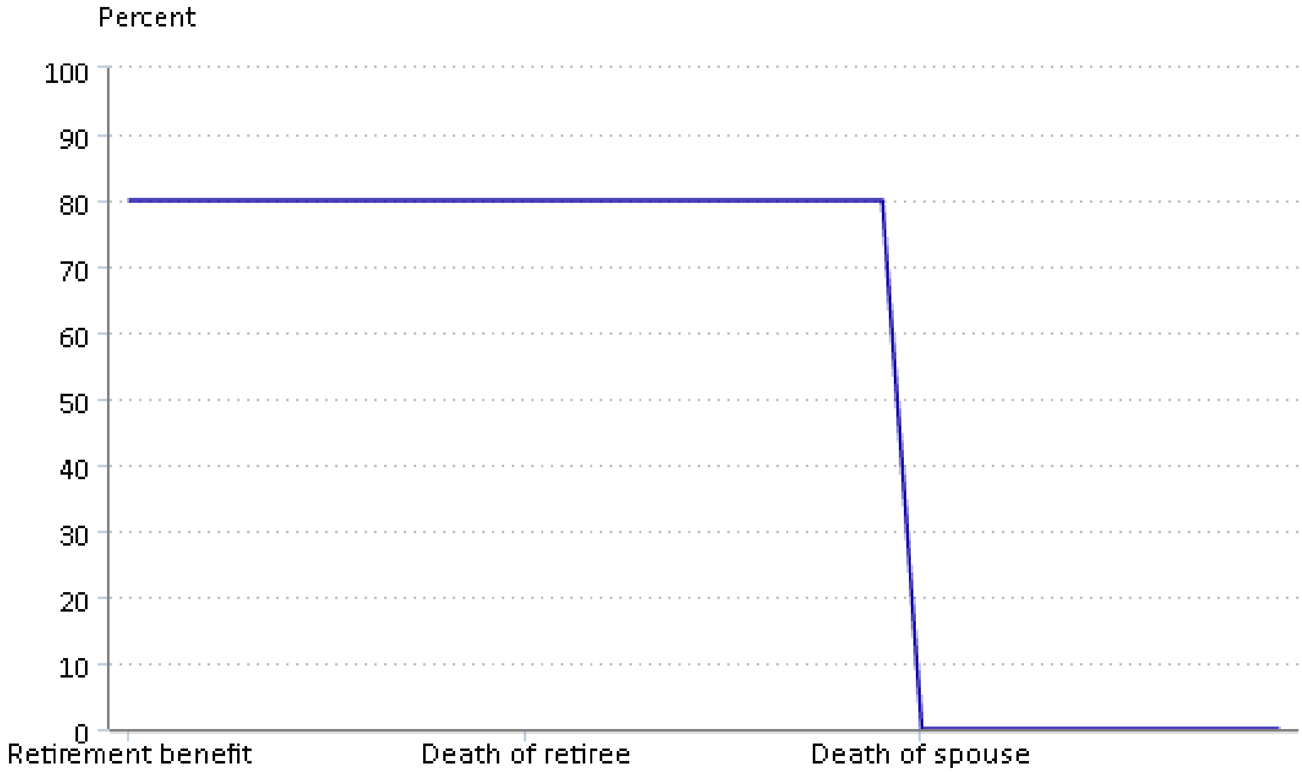
Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

Beyond these two required forms of payment, many plans allow retirees to choose alternative forms of payment. Opting for an alternative payment often must be in writing. In the case of married employees, the spouse must also agree in writing to an alternative payment.

Alternative: other survivor annuities

The required payment form for married employees, the 50-percent joint-and-survivor annuity, operates under the premise that the surviving spouse needs half of the income that was needed when both spouses were alive. To accommodate different circumstances, many plans offer alternative levels of survivor protection. A 75-percent joint-and-survivor annuity provides 75 percent of the joint annuity to the survivor and a 100-percent joint-and-survivor annuity provides 100 percent of the joint annuity (no reduction) to the survivor. Of course, to offset the cost of these additional survivor benefits, the joint annuity is reduced to a greater extent than is the case with a 50-percent joint-and-survivor annuity. Once again, the overall benefit amount is designed to be equivalent of a straight-life annuity; it is simply distributed differently over two lives. (See chart 3.)

Chart 3. One hundred percent joint-and-survivor annuity: percent of straight-life annuity



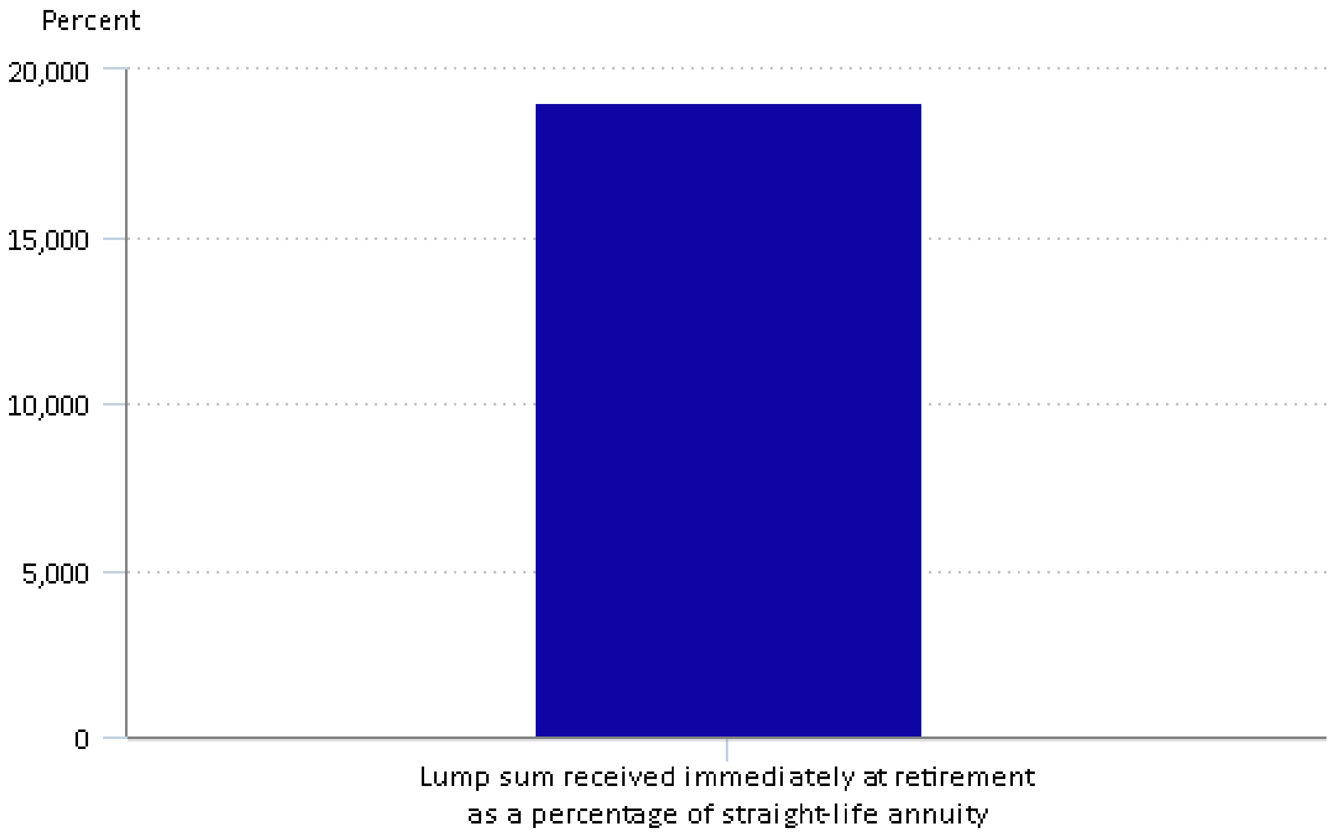
Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

Retirees may designate a survivor other than their spouse, although a spouse, when present, must consent to an alternate survivor. Certain circumstances may make the designation of an alternate survivor appropriate, such as when both spouses are receiving a pension or when there is a need to provide for another relative. Regardless of who is designated as the survivor, the reduction in the basic benefit will take into account the life expectancy of both the retiree and survivor.

Alternative: lump sum

A lump-sum payment may be the simplest alternative to understand, except again for the math. A plan may give retirees the option to take a single lump-sum payment, rather than a periodic annuity. If that single employee (mentioned earlier) chose the lump-sum payment after 40 years of service, he or she would receive 19,047 percent of a straight-life annuity or $228,564 dollars ($1,200 X 190.47) at the time of retirement. (See chart 4.) The lump sum equals the amount that must be invested today—given assumptions about life expectancy and investment returns—to produce a lifetime of payments. Choosing a lump sum eliminates the certainty of periodic payments for life and puts the retiree in control of the pace at which funds are used. Retirees may opt for a lump sum for a variety of reasons, including availability of other retirement income or assets, health status, or estate planning.

Chart 4. Lump sum at retirement as a percentage of a straight-life annuity



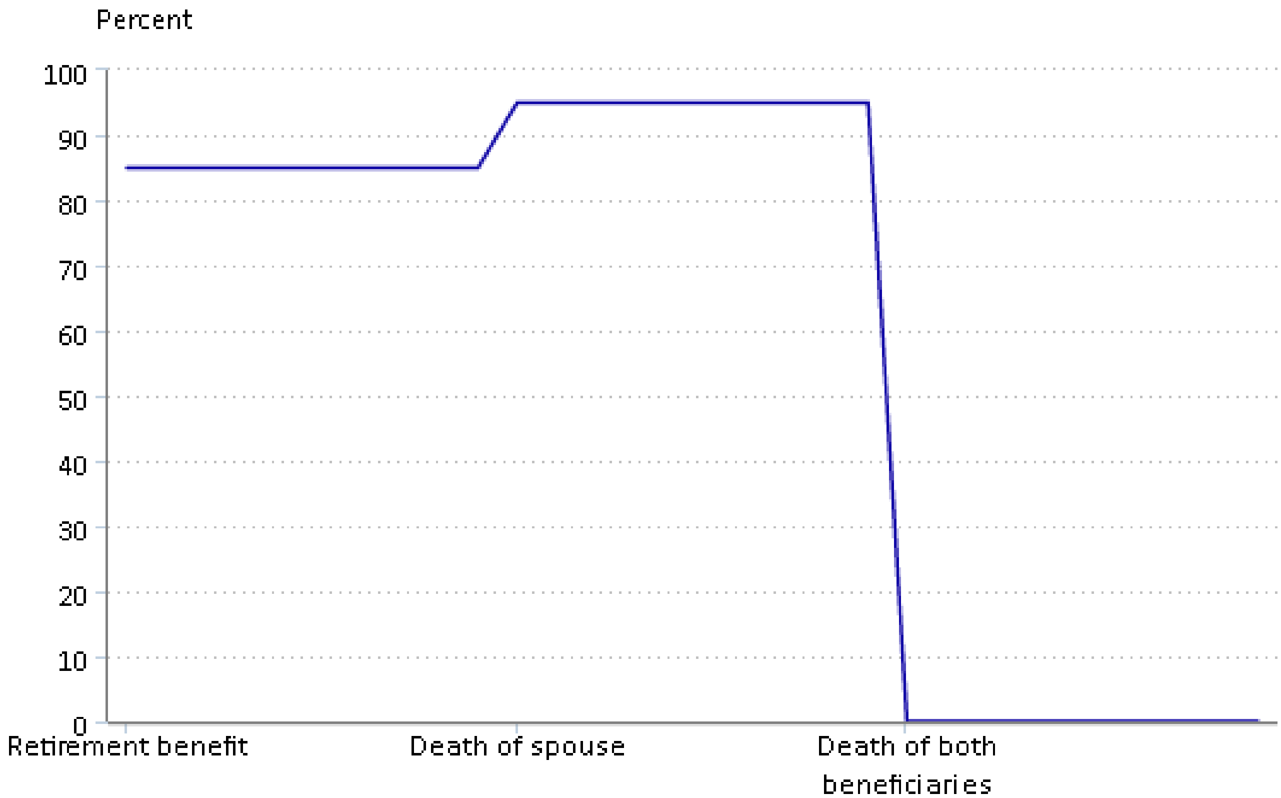
Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

Alternative: pop-up provision

A typical joint-and-survivor annuity, regardless of who is designated as survivor or the amount that the survivor will receive, assumes that the survivor will outlive the retiree. This is perhaps a relic of more traditional work and home arrangements, when men were the typical breadwinner. Because women have a longer life expectancy than men, the assumption is that the retiree is a man who will die before his wife. But what if the spouse—male or female—dies before the retiree? In most plans, the retiree continues to receive the (previously reduced) joint annuity until death. Retirees are not allowed to switch to a straight-life annuity nor are they allowed to designate a new survivor. Because the original annuity was reduced to offset the cost of a survivor benefit, the ultimate benefit received by the retiree will be less than equivalent to the straight-life annuity.

Some plans anticipate the possibility that the retiree will outlive the spouse by offering a pop-up feature, which increases the annuity payment upon the death of the spouse. The benefit “pops up.” Typically, the retirees pay for this protection through a reduction in their original annuity. (See chart 5.)

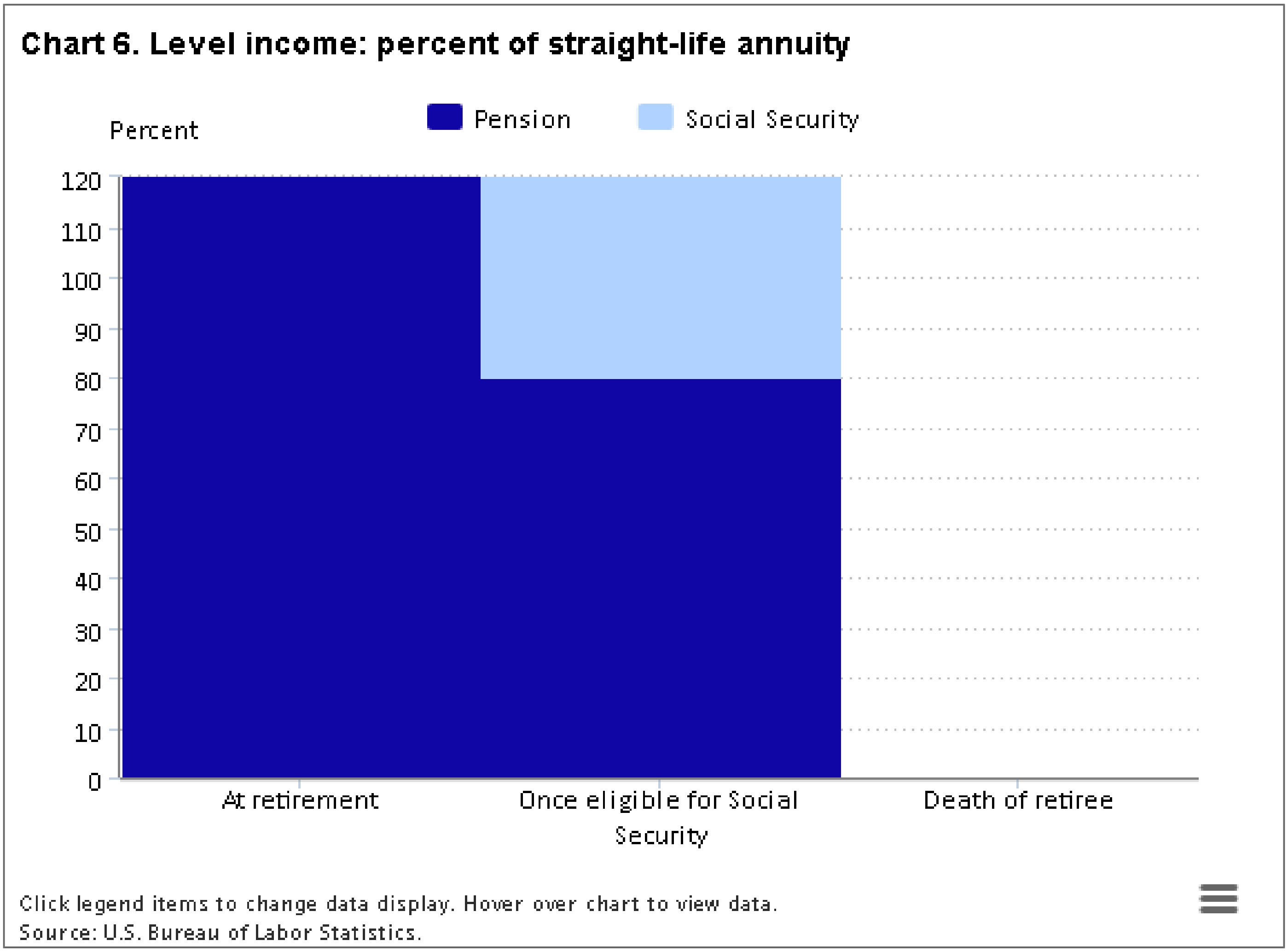
Chart 5. Joint-and-survivor annuity with pop-up: percent of straight-life annuity



Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

Alternative: level income option

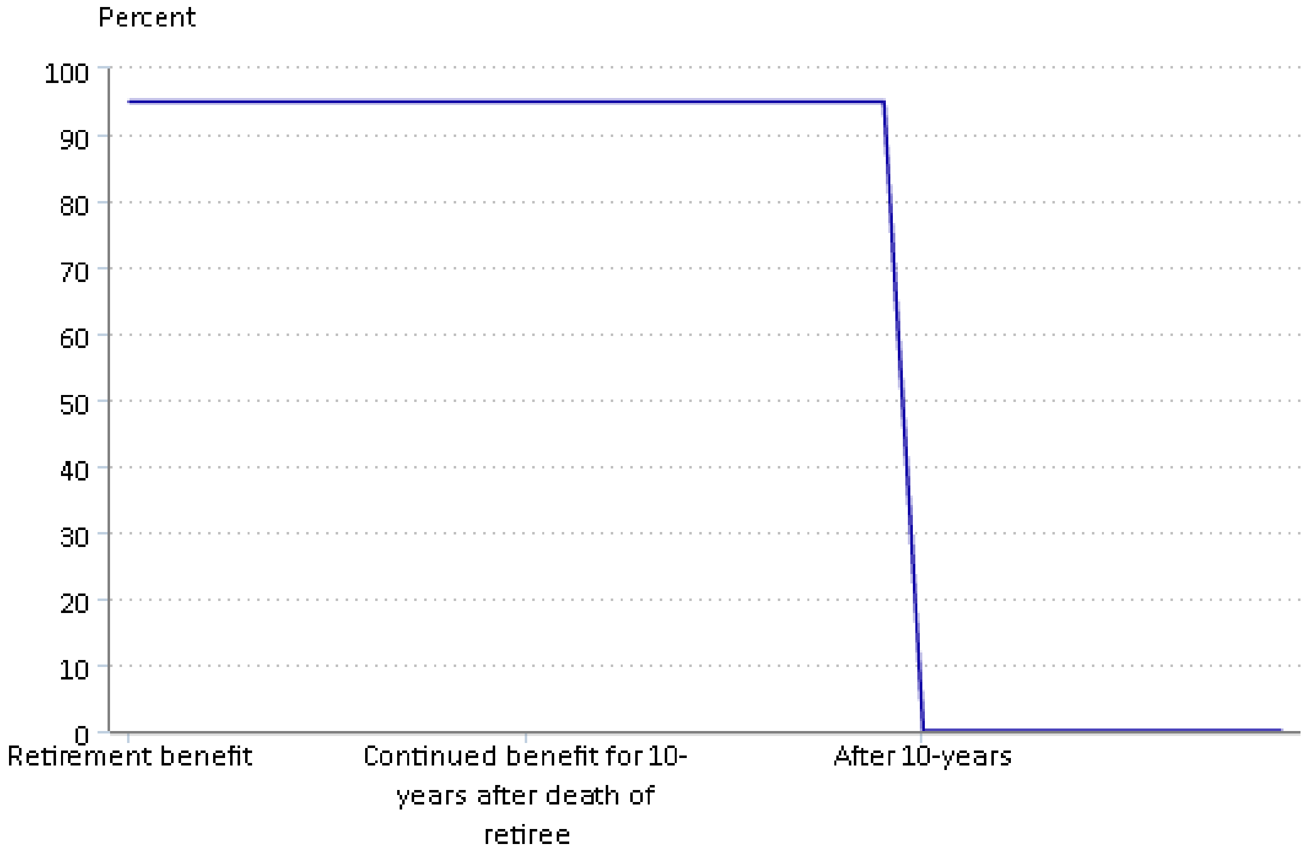
An employer-provided pension is only one source of retirement income; many retirees also receive monthly Social Security payments. Some employer pension plans offer a level income option for those who retire prior to Social Security eligibility. In such an option, the retiree receives a greater benefit prior to receipt of Social Security and a lesser benefit once Social Security payments begin. For example, if the accrued pension benefit were $1,000 per month and Social Security benefits were anticipated to be $800 per month; a level income option might give the retiree a pension of $1,600 per month at retirement then drop that benefit to $800 per month when Social Security begins. The retiree would continue to receive $1,600 per month, but from different sources. Such an option could be combined with a survivor option. (See chart 6.)



Alternative: period certain annuity

The final alternative is a hedge against the early death of a retiree and spouse. In the alternatives previously explored, benefits end upon the death of the retiree and spouse, regardless of how short or long a period of time they are received. In a period certain annuity, such as a 10-year certain annuity, benefits will be paid for at least 10 years. If the retiree (or retiree and spouse) are both deceased, benefits continue to a designated beneficiary or the retiree's estate for the period designated. (See chart 7.) Period certain annuities can be offered for different time periods, such as 10-year certain, 15-year certain, or 20-year certain. Retirees pay a cost for this guarantee through a reduced annuity. Such an alternative might be appropriate for an older retiree or those in poor health.

Chart 7. Ten-year certain annuity: percent of straight-life annuity



Hover over chart to view data.
Source: U.S. Bureau of Labor Statistics.

Put it all together

A pension may be thought of as a source of income for life. But the reality is more complex, with options to receive benefits in a variety of ways. The graphics presented here are intended to help illustrate the effect these various payment options have on periodic benefits.

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NOTES

[1] The percentage of accrued benefit shown in the accompanying charts are estimates, based on information gathered from pension plan documents. The actual amounts will vary based on plan features, plan assumptions, and the age and other circumstances of each retiree and spouse.

SUGGESTED CITATION

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