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## Past service: To buy or not to buy

Rayann Huang / July 17, 2009



Whether it's due to layoffs or career changes, a growing number of people are taking extended periods off work. For those with defined benefit pension plans, the long absence from work could erode the value of their pension entitlements.

Fortunately, one of the perks offered by most public defined benefit pension is the opportunity to buyback missed pension service.

In today's labour market, where people tend to change employers and careers more often, employees can sometimes find themselves back with their former employer. Upon their return they may be given an option to buyback their "cashed out service" or buyback missed service.

However, when it comes to advising clients on this topic, each advisor will view the question whether to purchase buyback from a different perspective. Even the math involved in the analysis is not a straightforward matter.

Frank Wiginton, senior financial planner with Tridelta Financial Partners, had a client who left the Ontario Power Generation to pursue a second career only to return 18 years later. Upon his return, the client was faced with the option of buying back the missed years of pension credit.

Determining the financial stability of the pension plan is the first step for Wiginton in the decision process.

"A big part of it is looking at the stability of the company. The reason why is, as we've seen with GM and Nortel, if there's no company to top up and support a pension, pension benefits can be substantially harmed or erased," says Wiginton.

He is particularly careful when it comes to private pension plan because during severe market downturns, oftentimes the corporation will not have enough assets to top off the shortfall in the pension assets, and, as a result the pension starts to "starve."

Daniel F. Stronach, a CFP at Stronach Financial Group Inc. in Toronto, says pension indexation tends to catch his eye.

"I would say that generally, whether the pension is indexed can prove to be significant, especially if there is an inflationary buzz that's coming forward," Stronach says. "For the most part if there is some solid indexing than it becomes very clear that it makes a lot more sense than going with traditional investments."

### Doing the number crunching

The math on buybacks is not a clear cut matter either because it relies on making assumptions.

Paul McVean, CFP, regional vice-president, wealth planning at United Financial Corporation/Assante in Toronto, recommends employing various assumptions to set parameters of expectations to help client determine suitability and risk. This method will allow the client can compare the increased pension amount after buyback with different investment returns

if they kept money outside of the pension.

"It's important that you don't just work with one set of assumptions, that you try and provide parameters around the comparisons rather than one answer to it because we don't know what the rate of return will look like and we don't know absolutely how long someone will live," says McVean.

To demonstrate the extent assumptions can affect results, McVean provided the following cost benefit analysis case study:

A client is a teacher in her late 30s to early 40s. Without buyback, the estimated pension was \$81,870 based on the average best five years salary of approximately \$150,000 per year, adjusted for inflation and assumes client will retire in 20 years.

The cost to buyback two to three years of past service is just under \$30,000 and will raise the annual pension to \$86,200 per year. Effectively, the buyback would raise the pension by slightly over \$4,330 per year.

Next, McVean uses the actuarial estimate that the individual will have 35 years of retirement. From here, two steps follow:

calculating present value of income stream of \$4,335 for 35 years.

then calculating present value of 35 years of income in 20 years time discounted to today's value (McVean uses a discount rate of 2.7% as this is what his firm uses for planning projections based on long-term inflation rate)

Based on the numbers, the increased pension (as a result of the buyback) will be worth \$29,000 in today's value. Comparing this value to the out-of-pocket amount to purchase buyback, \$30,000 would suggest that it does not make sense to purchase buyback, as the incremental pension amount is worth less than what it costs to purchase it.

But McVean cautions that a lot of the calculation hinges on two assumptions: a 6% rate of return and a 35-year retirement period. Changing assumptions will produce drastically different results.

For example, using the same client profile, but extending the retirement period to 40 years and using a 5% rate of return changes the result of the comparison so that the present value of the future additional pension is almost \$44,000 compared to the \$30,000.

Running the numbers is also important for objectivity. Though pension buyback typically doesn't involve sums over \$100,000, it still means an outflow of client assets.

According to Stronach, even though buybacks are normally not large amounts, an advisor, depending on how the advisor is compensated, may act on the incentive to manage the money.

"It's all about control over the money. I think a part of it may also be knowledge," he says. "There are a lot of people who really don't know how to value these things so they can do a quick napkin sort of analysis and say this is the way it is and make that sort of quick decision."

Although the cost benefit analysis can be a time consuming exercise, Wiginton says for advisors who have completed planning for clients, comparing income streams is as simple task as inputting the numbers provided by the pension administrator.

The comprehensive retirement cash flow analysis that he has prepared — usually takes up to 20 to 25 hours — for clients is what saves him from the even longer hours of number crunching. After obtaining information from pension administrator it's just a matter of plugging in numbers and seeing which scenarios show the most "bang for the buck."

A lot of the work is going to involve conversations with the client about liquidity needs and weighing importance of income stability over control of assets.

Though the topic of pension buybacks do not come up frequently, advisors will continue to run into it as long as defined benefits remain in the pension landscape and people continue to take extended absences from work.

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