

Pension Max Issues

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The default monthly benefit payout amount in most defined benefit plans is a percentage of (monthly) final average compensation times years of service credit. Commonly, defined benefit plans will offer retirees a choice between the formula benefit payable for the retiree's lifetime, and a lesser "actuarially equivalent" benefit that will continue to the retiree's beneficiary following the death of the retiree. For example, a retiree might be offered a choice between a pension of \$1000 per month payable for life, and, perhaps \$900 per month payable as long as either the retiree or the beneficiary is alive. The \$900 choice provides income protection for the beneficiary following the death of the retiree.

Of course, the retiree could also take the \$1000 per month and provide for the beneficiary (assuming there is one) in another fashion. One way to do this would be to buy a life insurance policy on the retiree's life. The eventual proceeds of the life insurance policy could be used to provide protection for the beneficiary following the retiree's death. If the cost of the life insurance is less than the amount that the retirement system charges for beneficiary coverage (\$100 in the example), and if the proceeds of the policy provide a benefit at least as great as the retirement system would have provided, the retiree has improved his or her financial situation. This idea is often referred to as "**Pension Max.**"

When does Pension Max Work?

There are a few clear-cut examples where Pension Max can work well by producing a higher total benefit than would come from the retirement system alone. For example, if the beneficiary dies before the retiree, premium payments to the Pension Max policy stop, whereas the pension reduction to provide survivor coverage through the retirement system may continue. Another example is where the beneficiary dies soon after the retiree dies, which may result in a lump sum payment from the Pension Max policy. Under the same scenario, pension payments from the retirement system would typically cease. Of course no one knows when either the retiree or the beneficiary will die. Also, if the beneficiary has a full pension of his or her own, he or she may prefer the lump sum available via Pension Max to the continuing income from the pension that could be provided by the retirement system.

Problems with Pension Max

There are many cases where Pension Max does not work well, and, in fact, the deck is, for the most part, stacked against retirees who choose Pension Max. Why is this? There are several reasons, a few of which are listed below.

- Insurance companies are in business to make a profit. The retirement system is a non-profit organization offering benefits to its members. Insurance companies charge policyholders more than the estimated cost of insurance. They charge an extra amount that is basically a contribution towards company profit. The retirement system does not intend to profit from people selecting beneficiary coverage. In fact, many retirement systems actually charge less than the cost of survivor protection when they calculate the pensions they will pay to individuals electing survivor coverage.
- Life insurance premiums would be payable from after (Federal) tax income, a fact that is easy to ignore in life insurance illustrations. In the \$1000 per month case discussed above, the retiree will pay tax on the whole \$1000 if Pension Max is elected. He or she would only be taxed on \$900 per month if survivor protection were elected through the retirement system.
- Public employee retirement systems periodically review retiree benefits for adequacy and provide inflation catch-ups for retirees. In addition to inflation catch-ups, retirement systems have also been known to provide direct benefit increases (multiplier increases, and the like) for past retirees. Life insurance companies almost never do any of these things.
- Retirement system benefits sometimes provide direct inflation protection in the form of fully or partially indexed benefits. If you live a long time, or if there is high inflation in the future, the insurance proceeds may be insufficient to provide a meaningful benefit to your beneficiary.
- Life insurance sales people sell life insurance products. Life insurance salespeople have a direct financial interest in selling you the product that provides the highest commission to them. Retirement system counselors have no financial interest in your decision. Their supervisors have charged them with providing you with unbiased facts upon which to base your decisions. They want you to make the right choice.
- Life insurance policies can be cancelled. Life insurance companies can go out of business. You may become uninsurable.
- If your physical or mental health declines in the future, you may forget to pay the premiums on the Pension Max policy. Your beneficiary may not be in a position to invest life insurance proceeds wisely after your death. Basically, any arrangement that requires continued positive action on the part of very old people is fraught with risk for the people involved.
- The retirement system may provide benefits such as subsidized health insurance to individuals who are drawing a monthly benefit. Your Pension Max beneficiary would normally not be eligible for such contingent benefits, and your Pension Max policy probably won't provide them either. For this reason, most people do not consider it wise to sever all connection with a public employee retirement system, which Pension Max does do for the beneficiary.

Additional Information on Pension Max

There is a great deal of literature available on the topic of Pension Max. If you are considering Pension Max, you would be well advised to learn as much as possible on the subject before making your decision. As a starting point, you might consider reading either

or both of two excellent articles by Jane Bryant Quinn, which can be found in the May 7, 1990 and April 4, 1994 issues of Newsweek, or downloaded from Newsweek.com for a fee. Other Internet sources to review include:

<http://www.urs.org/dbplans/pensionmax.html>,
<http://www.frs.state.fl.us/frs/public/penmax.htm>,
<http://www.ricedelman.com/planning/retirement/max.asp>.

Planning for retirement is not planning to get rich; rather, it is planning not to get poor. Pension Max is most appropriate for those cases where the beneficiary has little if any need for continuing monthly income from the retiree's pension. For other cases, its value is doubtful, and can have irreversible negative consequences, particularly for aged, dependent beneficiaries. Think carefully. Choose wisely.