

## When to retire: Age matters!

### Executive summary

Getting ready for retirement takes planning, and one key retirement planning aspect that cannot be overlooked is the timing of retirement. In Canada, there is no mandatory retirement age, but the age at which one chooses to retire will have important financial consequences. The timing of one's retirement and when one starts to withdraw from their savings may mean the difference between having a retirement nest egg that is more than adequate to last a lifetime, or running out of money and drastically cutting back on one's lifestyle during retirement. Making decisions about when to retire requires a careful examination of one's goals, finances and prospects – and often, the interaction of these variables can be complex. In this Report, the BMO Retirement Institute takes a closer look at the financial impact of the timing of retirement, with a view to helping Canadians identify the issues they need to consider when planning their retirement date.

The BMO Retirement Institute was established in 2008 to provide thought-provoking insight and financial strategies for those individuals planning for, or currently in, their retirement years.

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## When do you want to retire?

Getting ready for retirement takes planning – but considering that retirement is a destination where we hope to be for a long time, planning for the journey is one of the most important investments of time we can make.

Planning can be complex, however, because there are so many unknowns: What will the economy be like? What will happen to my investments? How long can I count on being healthy and active?

Canadians spend a lot of time pondering these variables, over which they have little or no control – and making choices based on how they assume things will turn out. Perhaps Canadians should be spending more time focusing on a variable that they can control more than most – namely, the age at which they choose to retire.

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For a time, many Canadians were choosing to retire sooner. From the mid-1970s, when the median retirement age (excluding those who retired before they turned 50) was 65, the median dropped to 60.6 in 1997 – a time when the public sector was offering early retirement incentives to cut payrolls. Since 1997, the median retirement age has inched back to 61.0 in 2005<sup>1</sup>. From then on, there is anecdotal evidence that the upward trend is continuing as many Canadians conclude they are not yet ready to leave the work force.

The BMO Retirement Institute's research in January 2009 revealed that more than half of the pre-retirees surveyed were considering putting off their retirement – and nearly half (45%) of those who were already retired said they would probably return to work over the next year. The same study also found that people seemed motivated to work longer out of necessity (“earning money”) rather than for self-fulfillment (“staying mentally active” and “keeping in touch with people”), which had been the main driver three years earlier. Of course, people were less confident about their futures in 2009, many having just witnessed the value of their assets tumble during the financial crisis.

This Report explores how one's choice of retirement age will impact the different sources of income used to fund Canadians' retirement lifestyles, namely, government pension plans, employer sponsored pension plans and personal savings and investments.

**OAS is not payable before age 65.**

**By 2016, starting CPP at age 70 versus at age 60 means collecting about \$100,000 more if one lives till age 90.**

## Government pensions

While retirement age may be taking on new meaning for many, it still generally means “65” to government pension plans: Old Age Security (OAS) and the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP).

In order to be eligible to receive maximum OAS benefits, one must have lived in Canada for at least 40 years after the age of 18. Immigrants who come to Canada after their 25<sup>th</sup> birthday will generally not be able to collect the maximum pension<sup>2</sup>. Since OAS is not payable before age 65, if one retires before then, another source of income will be needed to replace it. If one were to retire at age 60, for example, the amount that would have to be replaced, at today’s OAS rates, would add up to more than \$31,000<sup>3</sup> – a sum that the individual would have to fund from savings or other retirement assets.

CPP/QPP may begin before age 65 – or after. The size of the CPP/QPP benefit depends on how much has been contributed to the plan<sup>4</sup>. The payout will also vary up or down, depending on when one opts to begin collecting it. Under the current rules, the pension will be reduced by 0.5 per cent for every month prior to one’s 65<sup>th</sup> birthday, based on when the pension begins. In other words, by taking CPP/QPP at age 60, the monthly payment will be reduced by 30 per cent – and this reduction remains in place for the rest of one’s life. Conversely, the pension will be increased by 0.5 per cent for every month one defers drawing down the pension beyond age 65. By opting to take CPP/QPP at age 70, for example, the monthly payment will be increased by 30 per cent for the rest of one’s life.

The CPP<sup>5</sup> rules are about to change in a way that will discourage people even more from collecting early, while providing an even bigger incentive to wait. In 2016, when the new rules are fully implemented, taking CPP five years early will reduce the monthly payment by 36 per cent, while holding off for five years will boost the monthly payment by 42 per cent. The difference is significant. By 2016, the annual payment for a full CPP would be about \$4,000 less if one were to start to collect at age 60 – and about \$4,600 more if one were to wait until age 70. At age 90, the person who began drawing CPP at age 70 will collect about \$100,000<sup>6</sup> more from the CPP than the early retiree who began collecting CPP at age 60.

The total benefit a person will receive from CPP over a lifetime depends on the size of benefit the person is eligible for, when the person chooses to begin receiving the pension and for how long.

## Delaying CPP/QPP can substantially increase one's monthly benefits.

One can calculate the “break-even” or “cross-over” point at which one choice proves to be more advantageous, in terms of lifetime earnings, than the others. While it is impossible to predict life expectancy, to put it in perspective, individuals whose life expectancy does not exceed age 73 would be better off drawing their CPP at age 60 – notwithstanding the 36 per cent reduction in benefits under the new rules. Conversely, those who live beyond 81 would be better off drawing their pension at age 70 and taking advantage of the 42 per cent increase in benefits. For everyone in between, the best choice is to draw one’s pension starting at age 65<sup>7</sup>.

Waiting to apply for CPP/QPP can substantially increase one’s monthly benefits – thus reducing the share of retirement needs that must be met from other sources. And by contributing longer, the benefit could be increased even more since the amount of contributions made is a major determinant of one’s eventual benefits.

### Employer sponsored pension plans

Another potential source of retirement income is employer sponsored pension plans, of which there are two basic kinds: Defined Benefit (DB) plans, which provide a guaranteed pension for life, and Defined Contribution (DC) plans, which do not provide a guaranteed pension.

The retirement benefit under a DB plan is generally determined by the number of years the plan member has worked and contributed to the pension plan, as well as the level of compensation. Most DB plans define the normal retirement age as 65, but will typically allow access to pension income as early as 10 years before the normal retirement age. In return for this early access, the pension income is reduced by a percentage for each month the pension income starts before the normal retirement age is attained, and this reduction is permanent<sup>8</sup>. As Canadians are living longer, such a pension reduction can last for 30 to 40 years. In addition, some pension plans are “integrated” with CPP/QPP, such that the amount of pension benefit may be reduced at age 65. People whose pension plans contain this feature will need to take this into account when estimating their retirement income sources. Therefore, it is important to understand how one’s monthly income from a DB plan will change depending on when one chooses to apply for pension benefits.

With a DC plan, the level of retirement income depends on the performance of the portfolio in which the funds are invested. In

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this respect, DC plans are similar to personal savings plans such as Registered Retirement Savings Plans (RRSPs). At retirement, employees may decide to use the funds in the DC plan to purchase a life annuity, thereby creating a lifetime pension, or continue to manage the money in a locked-in registered account and make annual withdrawals from the account.

Having a company pension plan provides one with an additional source of retirement income, but does not necessarily guarantee that one will have adequate income during retirement. Most people will therefore also need to have their own savings to ensure they have sufficient income during their retirement years. (Refer to Case Study #1 in the Appendix for an example of the impact of timing of retirement on one's retirement income.)

### **Personal savings and investments**

The third source of retirement income is the nest egg one accumulates over a lifetime of working. This includes one's Registered Retirement Savings Plans (RRSPs), Tax-Free Savings Accounts (TFSAs) and non-registered assets.

As a general rule, a person who wants to retire earlier will need more retirement savings. This is because the earlier one retires, the less time one's retirement assets have to grow and the longer the period one will need to rely on them. The opposite, of course, is true as well: The longer one waits to retire, the more time one's retirement assets have to grow and the shorter the period one will need to rely on them. For assets accumulated in a tax-sheltered account such as an RRSP or a TFSA, the difference will be even more pronounced because the investment growth accumulates free of tax.

### **Easing into retirement**

For many individuals, the concept of retirement as a fixed date in time when one stops working is no longer relevant. Many people approaching retirement now see the shift as a transition period – one that may play out over a number of years.

Taking a phased approach to retirement enables one to reduce one's hours at work and free up time to engage in other pursuits, while at the same time continuing to generate an income – thereby postponing the moment at which withdrawals from retirement assets become necessary. Even if no further contributions are made to existing retirement savings, the phase-in period allows more time for those savings to grow. This may also mean additional time to pay down

mortgages and other debt. Entering retirement debt-free eliminates one more expense that will draw on resources. This can mean the difference between having sufficient resources to last into one's 80s and having the nest egg run out years sooner. (Refer to Case Study #2 in the Appendix for an example of the impact of timing of retirement on one's retirement savings.)

### **The timing of returns**

For those who rely heavily on their personal savings to fund their retirement income needs, the reality of market volatility cannot be ignored. We do not live in a perfectly controlled world where the rate of inflation is constant and investment returns are steady and predictable. In reality, market performance and real investment returns fluctuate year after year – and whether the market is up or down when it comes time to draw down one's assets will have direct consequences on all future withdrawals.

If, for example, a person's investment portfolio has experienced negative returns just as the person is about to make a withdrawal, the value of the portfolio may be eroded to a point where the retirement asset expires before its owner does. This is the challenge that faced many people on the verge of retirement in 2008, when markets – and the value of their investment portfolios – dropped precipitously.

Indeed, in 2008, the federal government was quick to acknowledge concerns expressed by seniors about the reduction in value of their retirement savings. The government addressed those concerns by permitting Registered Retirement Income Fund (RRIF) plan holders to reduce the required minimum withdrawal amount by 25 per cent for the year 2008 and encouraged Canadians to consider making in-kind withdrawals to minimize the requirement to sell investments that had gone down in value.

Conversely, a couple of years of double-digit returns just before retirement could fortify a retirement nest egg and significantly improve one's retirement lifestyle. No one can time the market and no one, therefore, can pick their date of retirement to coincide with a double-digit uptick in the stock market. However, those who are able to leave the retirement portfolio untouched and wait out recovery, rather than start to deplete an already shrunken asset, will be in a better position to weather such market volatility. For those who are approaching retirement (5-10 years before retirement), they should review their retirement plans with an eye to ensuring that their savings will last as long as they need them to. This may mean restructuring the portfolio allocation to ensure that a portion of it is invested in

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products that are not subjected to market fluctuations. Increased longevity, however, will mean that people entering retirement should still maintain investing for the long term – and, therefore, include investment vehicles that can potentially yield higher returns.

### Do what is best for you

The age at which one retires is one of the most important variables of a retirement plan – and, to the extent that individuals can control the choice, it is in their interest to do so because the age of retirement has a direct bearing on how much retirement savings will be needed and how long those savings will have to last. Being able to choose the timing of retirement in a way that optimizes one's government and employer pension incomes will also mean reduced reliance on personal retirement savings, thereby lessening the effect of market volatility on one's retirement income.

Of course, the decision involves more than money. For many, work provides mental stimulation, a social network and a sense of purpose. While individuals may be financially able to retire, it is important for them to think about how these psychological benefits will be replaced when one is no longer working – such as what they will be doing and how they will spend their time in retirement. The decision may also depend on one's marital status. Couples are more likely to have dual incomes and more access to health and pension benefits. They are also more likely to discuss their retirement plans together and gather the necessary information to create a joint retirement plan. Therefore, making decisions about when to retire requires a careful examination of one's personal goals and finances – and often, the interaction of variables can be complex.

In addition, deciding when to retire is not always entirely within one's control. Unpredictable events, such as company layoffs, accidents or illnesses, may occur, which will prevent an individual from working. The decision may be influenced by other factors, such as family responsibilities (e.g., the need to care for aging parents, a spouse/partner and/or dependent children). Building all these considerations into a written retirement plan with the help of a financial advisor will provide an opportunity to validate the assumptions and identify constraints and other possibilities to consider.

The age at which one retires is a consideration that should not be left entirely to chance or to custom. Canadians should think about what it means to them – and what it means to their retirement finances. The decisions they make will have a significant impact on their retirement well-being.

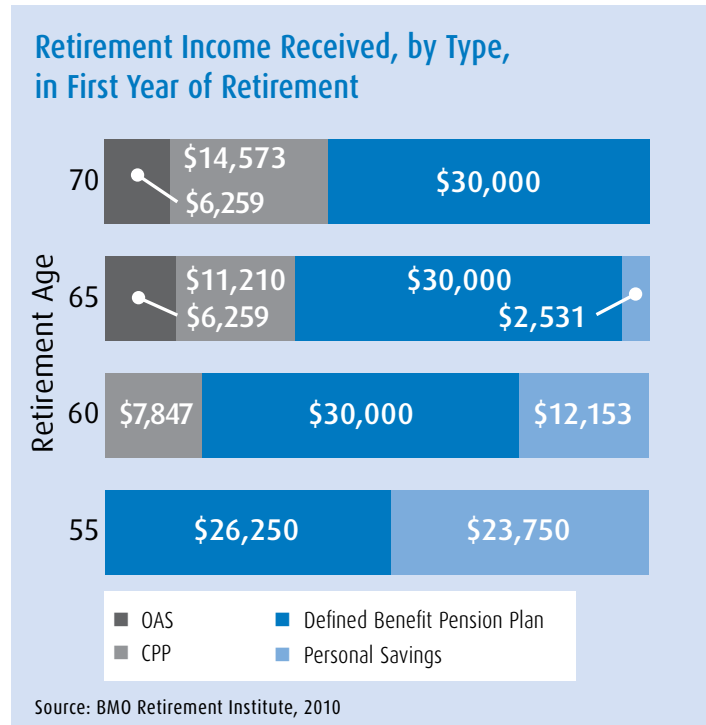
# Appendix

## Case Study #1

The following case study demonstrates how choices about retirement age can have a significant impact on levels of retirement income, by considering the situations of four individuals in nearly identical circumstances. They all retire this year. They are all eligible for maximum OAS and CPP<sup>9</sup>, and an inflation-adjusted defined benefit pension income of \$30,000 (a 2.5 per cent penalty applies for every year before age 60 that the pension begins). They all need pre-tax income of \$50,000 to sustain their retirement lifestyles. They differ only in their ages.

- Jérémie is 55 years old and his CPP and OAS payments have not yet started.
- Ping is 60 years old and has decided to begin taking CPP immediately. Under the existing rules, this decision to take CPP early reduces her benefit by 30 per cent. Her OAS payments have not yet started.
- Sashi is 65 years old and has also decided to begin taking CPP immediately but, having reached age 65, qualifies for the full benefit. Her OAS payments also begin at age 65.
- Tyrone is 70 years old and having deferred the CPP benefit for five years, qualifies for a benefit that is 30 per cent higher. He is already in receipt of OAS payments.

The chart shows the retirement income sources of each individual in the first year of retirement. Tyrone will be able to cover all retirement needs from pension income – without having to draw on personal savings. Sashi will have to draw on personal savings for about 5 per cent of the total. At the other end of the spectrum, Jérémie will need to



draw nearly \$24,000 from savings to top up pension benefits.

Even in ten years' time, when all four individuals are receiving OAS and CPP benefits, the individuals who retired sooner will have to continue to rely on personal savings to top up annual income requirements. Tyrone who chose later retirement (at age 70) will continue to meet all retirement needs from pension benefits.

## Case Study #2

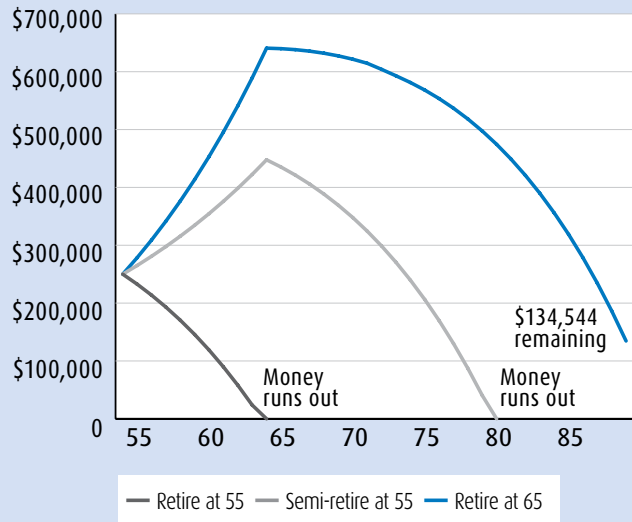
In this case study, we consider the situations of three 55-year-olds who have each accumulated \$250,000 in an RRSP and examine how long their retirement nest egg will last.

- The first individual has decided to retire immediately.
- The second will retire in ten years at age 65 and, until then, intends to continue contributing the maximum each year to the RRSP<sup>10</sup>.
- The third is also planning to fully retire at age 65 but, until then, will live in semi-retirement. During this 10-year transition period, the individual will neither make withdrawals from nor make further contributions to his/her RRSP.

All three individuals plan to withdraw \$25,000 per year (in today's dollars) from their RRSPs once fully retired. All three expect their average tax rate to be around 20 per cent. And all three expect to live to age 90. We also assume that the RRSP savings will grow at 6 per cent annually, and the inflation rate is 2 per cent.

As the chart shows, based on these assumptions, the individual who begins drawing down the RRSP immediately will run out of money before his/her 65<sup>th</sup> birthday – i.e., before the other two individuals have even begun to make withdrawals from their assets. The individual who continues to contribute to the RRSP for an additional ten years will have more than enough savings to reach age 90, and will be able to leave an estate to his/her heirs. And, by deferring

How long will the money last?



Source: BMO Retirement Institute, 2010

withdrawals from the RRSP for another ten years – during which time the savings will continue to grow – even the individual in semi-retirement will have enough funds to last until almost age 80.

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- (1) Perspectives on Labour and Income, Statistics Canada, released in February 2007.
- (2) These individuals may be eligible for government pensions from other countries where they have lived and worked, and should ensure that they explore these possibilities and take them into account when formulating their retirement plans.
- (3) This calculation is based on replacing the current OAS maximum monthly benefit of \$521.62 for 5 years (based on Service Canada figures for October - December 2010) and ignores any future increases to the benefit to reflect cost of living increases.
- (4) Thus, while the current maximum retirement benefit under CPP at age 65 is \$934.17 per month (for 2010), the average benefit in July 2010 is only \$505.09.
- (5) QPP benefits are calculated under a separate set of rules, and to date the QPP has not announced any change.
- (6) This calculation is based on the following assumptions: 100% eligibility for CPP, life expectancy of age 90 and full implementation of the new CPP rules. Based on these assumptions, the person who takes CPP at age 60 will receive reduced CPP for 30 years at 64% of \$934.17 monthly, for a total lifetime amount (ignoring inflation adjustments) of \$215,233, while the person who takes CPP at age 70 will receive increased CPP for 20 years at 142% of \$934.17 monthly, for a total lifetime amount (ignoring inflation adjustments) of \$318,365.
- (7) Based on the 2010 CPP maximum monthly retirement benefit of \$934.17. These calculations assume the full implementation of the new CPP rules (i.e., 2016 onwards), ignore any future increases to the benefit to reflect cost of living increases and do not assume that CPP funds received are being invested.
- (8) Some pension plans waive the reduction requirement once a plan member has reached a certain combination of age and years of plan membership.
- (9) For the purpose of this illustration, we assume that all four individuals are eligible for maximum CPP benefits. In reality, a person's CPP benefits are dependent on the amount of contributions made during his/her working life, so a person who retires at age 55 or 60 may or may not have contributed sufficiently to qualify for maximum CPP benefits.
- (10) Assumptions: This individual earns \$75,000 annually (the salary is growing by the inflation rate of 2 per cent), has no pension adjustment and has no RRSP carry forward contribution room.