Annuity Options in Public Pension Plans:
The Curious Case of Social Security Leveling

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Acknowledgements

This research is part of an on-going project that is being conducted in partnership with the North Carolina Retirement Systems Division and is being funded by the Sloan Foundation, Grant Numbers 2013-10-20 and G-2016-7054. The opinions and conclusions expressed herein are solely those of the authors and do not represent the opinions or policy of the North Carolina Retirement System or any other institution with which the authors are affiliated.
Introduction: Navigating Retirement Decisions

- At retirement, choice of annuity type from a defined benefit (DB) pension can be complicated.
- Present value calculations require knowledge about survival, market interest rates, and personal discount rates.
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- Can retirees successfully navigate this decision?
The Curious Case of Social Security Leveling

- Social Security Leveling is an annuity option allowing for level income before and after age 62:
  - Larger pension benefit prior to age 62.
  - Pension benefit is reduced by amount of *expected* Social Security benefit after age 62 regardless of claiming.
- “Borrow” from future pension benefit to have level income.
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This paper:

1. Which individuals might most benefit from leveling?
2. Do characteristics of levelers match with predictions?
3. Do retirees have sufficient financial knowledge?
4. Do retirees express ex post “regret” over the decision?
North Carolina Public Sector Retirees

- **Data**: Survey of 2009-2014 Benefit Claimants merged to admin records
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- Relatively young ages at claiming (avg. 60.7 years):
  - 51% retire prior to age 62
- Typical DB structure: \( B_{MAX} = \text{Early} \times M \times YOS \times FAS \)
  
  Multiplier M is 0.0185 for LGERS and 0.0182 for TSERS
- 6 annuity options:
  - 4 J&S and 2 single-life options
  - Cost-neutral to the *retirement system* and gender-neutral
  - Assumed interest rate is 7.25%
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- **Sample**: Retired before 62 and chose S-L, N = 2,256.
The Curious Case of Social Security Leveling

- Leveling not uncommon in public plans.
  - 20 out of 85 large state-managed public plans have a level income option (Clark & Cowell 2016)
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- NC SS Leveling formula relative to Maximum Benefit:
  \[ B_{LEV}^1 = B_{MAX} + SS \times F \]
  \[ B_{LEV}^2 = B_{LEV}^1 - SS \]
- F is cost-neutral to the retirement system at 7.25%.
Hypothetical Leveling Benefit

Assumptions:

- Claim benefit at age 57
- Maximum single-life benefit of $2,000/month
- Social Security benefit of $1,200 at age 62
- Uses actual reduction factor with 7.25% discount rate.
The Curious Case of Social Security Leveling

- Is higher initial benefit appealing to those lacking financial sophistication?
- How big a mistake could people make in present value terms?
Hypothetical Leveling Benefit

**Present Value** depends on assumed Personal Discount Rate

<table>
<thead>
<tr>
<th>Discount Rate</th>
<th>SS Leveling</th>
<th>Maximum Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>$569,834</td>
<td>$639,017</td>
</tr>
<tr>
<td>2.9%</td>
<td>$401,727</td>
<td>$429,908</td>
</tr>
<tr>
<td>7.25%</td>
<td><strong>$272,972</strong></td>
<td><strong>$273,024</strong></td>
</tr>
<tr>
<td>14.5%</td>
<td>$179,203</td>
<td>$163,598</td>
</tr>
</tbody>
</table>

Percent Difference: (Maximum - Leveling)/Maximum

- 11%
- 7%
- 0%
- -10%

Assumptions:

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- Social Security benefit of $1,200 at age 62
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Who benefits most from leveling:

- Less patient and high personal discount rate
- Shorter life expectancy
- Less wealth accumulated, higher cost of borrowing
- No other source of income:
  - No spouse income
  - No work after retirement
Social Security Leveling and Consumption Smoothing

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Ambiguous predictions:

- Age at retirement
- Poor health
- Attitudes towards risk
Multivariate Regression Results: Who Chose Social Security Leveling?

Results:

- Personal discount rate (hypothetical choice questions):
  - More impatient chose leveling
- Life expectancy (demographics):
  - Men, minorities, and lower educated chose leveling
- Wealth and access to income and low cost borrowing:
  - Lower savings and wealth, lower educated chose leveling
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Financial Literacy:

• No relationship with financial knowledge questions
Multivariate Regression Results: Who Chose Social Security Leveling?

<table>
<thead>
<tr>
<th></th>
<th>SS Leveling</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>0.055</td>
<td>(0.025)**</td>
</tr>
<tr>
<td>Married</td>
<td>-0.008</td>
<td>(0.019)</td>
</tr>
<tr>
<td>Non-Hispanic Black</td>
<td>0.158</td>
<td>(0.026)**</td>
</tr>
<tr>
<td>BA Degree</td>
<td>-0.056</td>
<td>(0.024)**</td>
</tr>
<tr>
<td>Age at Claiming</td>
<td>-0.036</td>
<td>(0.003)**</td>
</tr>
<tr>
<td>Initial Benefit Amt ($1K)</td>
<td>-0.039</td>
<td>(0.011)**</td>
</tr>
<tr>
<td>Impatient: Benefit Frame Only</td>
<td>0.055</td>
<td>(0.029)*</td>
</tr>
<tr>
<td>Impatient: Lottery Frame Only</td>
<td>0.066</td>
<td>(0.027)**</td>
</tr>
<tr>
<td>Impatient: Both Frames</td>
<td>0.092</td>
<td>(0.028)**</td>
</tr>
</tbody>
</table>

N = 2,256, Mean dep. var. 0.317. Add’l covars: other race/ethnicity, YOS, risk aversion, item non-response indicators, agency type, and year of claiming.

* p<0.1; ** p<0.05; *** p<0.01
Navigating Retirement Decisions

- Consumption smoothing assumes perfect knowledge.
- Myopic Benefit Maximization:
  - Is higher initial amount attractive?
  - Do people realize benefit will drop at age 62?
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- **Myopic Benefit Maximization:**
  - Is higher initial amount attractive?
  - Do people realize benefit will drop at age 62?
- Ex post reports of retirement decision-making:
  - Saved enough
  - Maintain standard of living
  - Had enough information
- Some survey respondents had crossed age 62 threshold
- Regression includes all covariates:
  - Demographics, YOS, year of claiming, etc.
Navigating Retirement Decisions

Saved Enough

SS Leveling *  
Current Age < 62 -0.054  
(0.028)*

SS Leveling *  
Current Age >= 62 -0.090  
(0.036)**

Current Age >= 62 0.061  
(0.037)*

Number of Obs. 2,146
Mean Dep. Var. 0.335

Levelers are significantly less likely to report believing they had **saved enough** for retirement while working.
Navigating Retirement Decisions

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<tr>
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<th>Maintain Standard of Living</th>
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<tr>
<td>SS Leveling *</td>
<td>-0.054</td>
<td>0.076</td>
</tr>
<tr>
<td>Current Age &lt; 62</td>
<td>(0.028)*</td>
<td>(0.031)**</td>
</tr>
<tr>
<td>SS Leveling *</td>
<td>-0.090</td>
<td>-0.015</td>
</tr>
<tr>
<td>Current Age &gt;= 62</td>
<td>(0.036)**</td>
<td>(0.039)</td>
</tr>
<tr>
<td>Current Age &gt;= 62</td>
<td>0.061</td>
<td>0.069</td>
</tr>
<tr>
<td></td>
<td>(0.037)*</td>
<td>(0.040)*</td>
</tr>
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Number of Obs.          | 2,146        | 2,138                       |
Mean Dep. Var.          | 0.335        | 0.530                       |

Levelers are significantly more likely to report being able to maintain their standard of living, but only prior to age 62.
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<table>
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<tr>
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<th>Maintain Standard of Living</th>
<th>Had Enough Info</th>
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<tr>
<td>Current Age &lt; 62</td>
<td>-0.054</td>
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Number of Obs. 2,146 2,138 2,151
Mean Dep. Var. 0.335 0.530 0.841

Levelers significantly less: had enough information to make good decisions regarding retirement only after age 62.
Summary:
The Curious Case of Social Security Leveling

- Observed annuity type consistent with predictions:
  - Impatience in hypothetical choice questions.
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  - Lower wealth and assets, lower human capital
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- Ex post measures:
  - Levelers report not saving enough for retirement.
  - Levelers have higher standard of living prior to age 62.
  - Levelers report not having had enough information.
Conclusions

- Leveling enables young retirees to smooth consumption.
- High interest rate yields a lower PV under “reasonable” assumptions of personal discount rates.
- Evidence suggests a role for better information.

- Overall, we find that public sector retirees in NC are successfully navigating this retirement decision.
Related Questions for Future Work

1. Does Social Security Leveling influence other aspects of the retirement process?
   • Disincentivize saving for retirement?
   • Allow workers to retire earlier?
   • Reduce work after retirement?
   • Earlier Social Security claiming?

2. Does this affect retirement income security?

3. Should the plan adopt a lower discount rate?

4. If so, what are the implications of offering a leveling option for age 66 or 70?
North Carolina Retirement Transitions Study (NCRTS)

- Part of a larger 6-year project on public sector retirement
- 2014 Active Worker Cohort Surveys 2014, 2016, & 2018:
  - Planning for retirement
  - Retirement timing
  - Health and caregiving
- 2009-2014 Benefit Claimant Cohort Surveys 2015 & 2017:
  - Annuity choice at retirement
  - Post-retirement employment
  - Retirement-income security and well-being