WORKING PAPER

Choices and Information Needs for Workers Leaving the North Carolina State Retirement Plan

Accepting a Lump Sum Payment or Receiving an Annuity at Retirement

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QUICK TURNAROUND PROJECT

Choices and Information Needs for Workers Leaving the North Carolina State Retirement Plan: Accepting a Lump Sum Payment or Receiving an Annuity at Retirement

Executive Summary

Each year, millions of American workers leave their jobs either by choice or due to termination by their employer. Many of these job changers were participating in defined benefit pension plans at their job. As a result of the separation, these workers are often given a choice of leaving their money in the pension plan or accepting a lump sum distribution of pension assets. The default is to remain in the pension plan and to anticipate that they will receive an annuity, based on salary and service at termination, when their age and years of service qualify them for retirement benefits. In plans that offer a lump sum distribution, usually the worker is told the value of the distribution[1] and given a choice of whether she wants to roll the funds over into an IRA or to accept the cash as taxable income and also pay a tax penalty for an early withdrawal. This choice can have significant long run implications for future retirement income.

This project examines the choices made by terminating workers who participated in the North Carolina Teachers' and State Employees' Retirement System (TSERS) and those in the North Carolina Local Government Employees' Retirement System (LGERS). While these plans have separate governing boards, they are administered by the same staff and have similar, but not identical, benefits and contributions requirements. The project examined all terminations from state and local government employment in North Carolina between 2000 and 2009.

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[1] In the private sector, the lump sum is typically calculated as the present value of future retirement benefits discounted back to the time of departure. Private sector plans usually do not entail employee contributions. In the North Carolina retirement system, the lump sum distribution is the equal to employee contributions and for vested participants, the accumulated interest on these contributions.

The state retirement system agreed to provide the investigators a comprehensive data file that included all relevant economic and demographic data on all individuals who left state or local employment between 2000 and 2009. The complete data file contains records on nearly 400,000 employees who terminated their service during this period. The data file allows the investigators to examine three key decisions associated with the retirement plan:

- Did the departing worker opt to accept a lump sum distribution as defined in the terms of the pension plan or did they leave their funds in the plan so as to ultimately receive a retirement annuity?
- Did the departing workers who withdrew the funds chose to directly accept the distribution or did they have the monies deposited in another retirement account such as an IRA?
- Are departing workers making different decisions after the introduction of additional financial information resources being provided to plan participants?

For this project, we have defined a lump sum distribution as individuals who accepted a lump sum distribution within one year of separation. This leaves two other categories of separating employees. First, there are those individuals that left their jobs and within a year started their pension annuity (these workers can be thought of as retired). The second group consists of workers who left their jobs and within one year had not requested a lump sum distribution. In this research, these workers are considered to have rejected the lump sum and are planning on accepting an annuity when they reach the retirement age set by the plan. One should remember that these workers can still elect a lump sum distribution at any time up until they start receiving a retirement benefit. Having decided on a lump sum distribution, the departing worker must then decide whether to directly accept the funds or roll the money over into another tax qualified

retirement plan. This choice has significant tax implications as well as influencing retirement saving and future income in retirement. If funds are rolled over and kept in retirement accounts, retirement savings will be much less affected by the job change than if these monies are accepted by the individual and possibly spent on immediate consumption.

Several patterns are clearly shown in the data and conform to economic predictions. Workers whose retirements are far off in the future or whose account balance is small will be more likely to withdraw funds. Similarly, workers that will have access to a pension at another employer or who are financially constrained at the time of separation might find it optimal to withdraw funds. On the other hand, some workers may separate from the public sector temporarily and be planning to return at a future date, so therefore chose to leave even small accounts open. Indeed, the researchers find that younger workers are more likely to accept lump sums as are those with fewer years of service and lower incomes. Women are more likely to leave their monies in the retirement system than men, perhaps due to a higher probability of the separation being only temporary. In addition, participants in TSERS are more likely to retain their funds in the system compared to those in the LGERS. The findings of this Quick Turnaround Project provide unique and important information concerning the decision to accept a lump sum distribution from a defined benefit plan.

In 2007 there were substantial improvements to the procedures for disseminating information to separating workers. The researchers find that workers that separated after 2007 were significantly less likely to withdraw their funds from the system relative to their counterparts who separated in prior years. More research is needed to understand how workers make these choices and what types of information separating workers need to make optimal decisions.