

Deferred Retirement Option Plans

DROP

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UFCW Unions and Employers Midwest Benefits Funds
Skokie Police Pension Fund

IGFOA Pension Institute - April 10, 2003

DROP Plans

Require Illinois Legislative Sanction

WHY ?

They change the Definition
of Credited Service

They change to Payment Rules

Activity Today:

DROP Defined

Sample DROPs from around the Country

Cost and Policy Issues

History and Growth

Advantages and Disadvantages

DROP–Like Variations

Illinois Legislative Prognosis

Surprise Issue

DEFINED BENEFIT REVIEW

Credited Service earned while working

After certain accumulation, VESTING occurs

At Retirement Age,
Pension is based on Credited Service
and Salary at Retirement

Many Plans have Cost of Living Adjustment (COLA)
at certain age or Retirement Duration Points

DEFINED BENEFIT - Example

Illinois "Downstate" Police Systems

24 Years of Service

Age 50

\$ 50,000 Salary

Pension is 60% of Salary (24 years X 2.5%)

Pension is \$ 30,000 or \$ 2,500 monthly

TYPICAL DROP PLAN

Upon attaining specific **age** and **service**,
employee "**retires**" from Pension System

Employee continues working for agency,
receiving all pay and benefits other than Pension accruals

While still working, the Monthly Pension
is deposited or credited to an account
on member's behalf (**DROP Account**)

DROP account accrues investment earnings/loss
based on specific provisions

When employee actually leaves employment,
monthly Pension is paid to him/her and proceeds of DROP
account are also available for payment or IRA rollover

DROP - Example

Typical Design:

Requires 23 years of service, age 50
3 year DROP minimum, 5 year DROP maximum
Final Retirement must occur after 5 years
Earnings to DROP account accrue at fixed 4%
Employee contributions cease during DROP
No Pension credit earned during DROP

DROP - Example - Continued

Sample Retiree: Monthly Pension of \$2,500
Spends 5 years in DROP Plan

Election: April 1, 2003
Final Retirement: April 1, 2008

Pension at "Retirement" Credited to DROP	\$ 2,500
DROP Account on April, 2008	\$ 166,000
Approx. Value of Redirected Employee Contributions	\$ 22,000
Total Gain:	\$ 188,000
Pension: April, 2008	\$ 2,500

TYPICAL DROP FEATURES:

Age and Service Eligibility Rules

Minimum and Maximum Periods Defined

Rules on what happens if the
minimum/maximum periods are not met

Rules on how are earnings credited

Coverage or not for Duty Disabilities

Cessation of contributions from
employee during DROP period

Drop credits include/exclude COLA increases?

ACTUAL DROP – STATE of ALABAMA

25 Years of Service - age 55 required

3 Years Minimum - 5 Year Maximum

Voluntary quits before 3 Years lose DROP account

Contributions Continue – BUT TO THE DROP ACCOUNT!

No Service Purchases during DROP

No COLA during DROP, but paid beginning at receipt of Pension

Allowed to continue work after 5 years

4% Fixed Earnings

State of Alabama – DROP Earnings Schedule

Duration

DROP Account Value as Multiple of Monthly Pension

3 Years

38.21

4 Years

51.98

5 Years

66.30

Actual DROP - CITY of PHILADELPHIA

10 Years of Service

No Employee Contributions During DROP

No Minimum Period - Maximum 4 Years

Employee **Must** Leave Employment After 4 Years

Duty Disability Payable

No info available on Credit of Earnings

Actual DROP - DAVIE (FL) POLICE DEPARTMENT

Very Interesting Structure
DROP election allowable only at 20 Years of Service
No Minimum – 5 Years Maximum
Employee Must Leave Employment After 5 Years
No Employee Contributions, No Disability Benefits
Earnings/Losses experience by Fund credited to DROP
\$ 10 service fee per month
Many payment options at withdrawal time
Third-party administrator: “The guys love it”

Actual DROP - St. LOUIS POLICE

20 Years of Service - age 55

No contributions during DROP

No COLA Benefit During DROP

Earnings/losses experience by Fund Credited to DROP

Disability Benefits Payable

Special Feature - Employee Must meet with
a DROP counselor

SUMMARY of FEATURES:

Ages and Service Defined

Earnings in DROP Defined

COLA "yes" - COLA "no"

Minimum and Maximum Period Defined

What happens if Minimum Missed?

What happens when Maximum Reached?

Are Disability Benefits in force?

ADVANTAGES - DISADVANTAGES PUBLIC EMPLOYEE

ADVANTAGES:

The financial gain from receiving Pension, avoiding contributions and continuing Employment surpasses the financial gain from additional service credit and salary increases.

Secondarily, once in control of the DROP account, a Retiree benefits gains if superior investment earnings are attained.

Note: Superior investment earnings are difficult to attain.

DISADVANTAGES - PUBLIC EMPLOYEE

Extraordinary increases in Pension benefits are forfeited once DROP is elected:

High inflation effect on Salary

Promotion

Plan Benefit Improvement

Disability benefits may be forfeited,
(but member still would get a retirement Pension,
DROP proceeds, and worker's compensation payments)

ADVANTAGES - PUBLIC ENTITY

“A solution in search of a problem” ?

- Daniel Patrick Moynihan

Not quite - DROP provides a strong employee retention benefit to the Public Employer

DISADVANTAGES - PUBLIC ENTITY

“Cost Neutrality” may be missed

Potential Fiduciary Liability

Administrative Burden

IS THERE COST NEUTRALITY ?

Pretty close to it – gain to employee is offset by savings to the Employer when a year of work is performed without any Pension benefit being accrued.

Some things can diminish cost neutrality:

- Disability Benefits without an employee contribution

- Disproportionate number of early retirements

- Adverse selection by persons with no survivors

Some can be mitigated - Some can't.

FIDUCIARY LIABILITY RISK

Disgruntled Employee who didn't understand it
might work against him/her
(Solution: State Indemnification, counseling)

Persons dissatisfied with actual Fund
investment performance
(Solution: Fixed-rate credit, indemnification)

ADMINISTRATIVE EASE

(these suggestions have other ramifications)

Fixed rate earnings (Alabama chart)

No COLAs during DROP

Employee must retire at the end of
maximum period

IS DROP A GOOD IDEA ?

I don't know - but it is coming.....

Growth has been explosive -

Louisiana, California, Alabama
Arkansas, Florida, Texas

State and Municipal alike

Google "Deferred Retirement Option Plan"
and see what comes back

ILLINOIS PENSION LEGISLATION

Major changes subject to negotiations

Then, no new issues considered for agreed upon period following major changes

DROP or variant will come up next time

Be ready with the features you want

DROP VARIATION - THE "BACK DROP"

No advance election made

At retirement, an option to take a few years accrued benefit in a lump-sum is given

Example – a person with 28 years of service takes a Pension based on 25 years and lump-sum payment based on 3 years of accrual, actuarially determined

Advantages - easy, very close to cost neutral

Disadvantage - not worth as much to the employee, and still some problems with adverse selection

Question: Does spouse have to sign-off on the lump-sum payment ?

DROP CONCLUSION



QUESTIONS



UNSCHEDULED TOPIC

