SOCIETY OF ACTUARIES

6. Employee Perspective

6.1 Why Does DROP Cost Anything?

Consider a DROP account that accumulates (with a market interest rate) 100% of the annuity that would have been paid to a participant had he retired. This would include any "retiree" COLAs. Assume that any employee contributions are discontinued after joining DROP. From the employee's perspective, this looks like a no-cost option since the ultimate payout equals what the plan would have paid out had the participant retired when he elected DROP.

Actuaries discount benefit payments to reflect events that are likely to occur. These events are not necessarily the worse-case scenarios and therefore the resulting contribution rate would be discounted. Examples include:

1. Discounting for anticipated terminations prior to vesting (in some plans there is no vesting until retirement age).

2. Assuming only a fraction of employees will be eligible for immediate disability benefits even though this benefit might require the largest immediate reserve.

3. Assuming that some employees will continue to work past NRA even though retiring at NRA may produce the largest present value (and normal cost or actuarial liability) of any service retirement assumption.

In the last two situations employees will expect to receive a disability or service retirement benefit when they qualify even if this creates plan experience that is less favorable than assumed. In the common DROP context it is only natural that employees not appreciate the distinction that there is a cost since: (1) the DROP ratio is greater than 100% and (2) they did not actually retire when they elected DROP. This can become a real communication problem when you have identical police and fire plans but the police have higher retirement rates (and experience). Adding a DROP might only have a cost for firefighters and not police officers.

To create cost neutrality, two changes commonly considered are: (1) “deposit” less than 100% of the annuity into the DROP account and (2) delay the DROP eligibility age from NRA to an age closer to the actuary’s assumed retirement age. The first option will appear to be “unfair” to many employees but creates what many actuaries think is close to true cost neutrality assuming the DROP ratios are close to 100%. The second option will still create DROP ratios of over 100%, even if at ages that active employees seldom reach.

In the prior paragraph we have been intentionally vague on the definition of cost neutrality. To some cost neutrality means that the DROP ratio is always 100%. Using that definition, option two (delaying DROP eligibility age) fails the neutrality test. To others the definition of cost neutrality means that the current contribution rate does not change. By this definition a DROP can be cost neutral (or a cost reducer) if the DROP eligibility age is after the latest assumed retirement age. For others a more sophisticated measure may be required such as the two approaches discussed in Section 4.7.

6.2 Factors Influencing an Individual’s Selection

Employees early in their careers often plan on working until NRA. As they get closer to NRA, they may like the comfort and security of being able to quit when they want to but decide to continue to work on a year-by-year (or month-by-month) basis. In their planning, an employee often factors in the annuity benefit they will receive beginning at NRA (e.g., 50% of pay plus a COLA). Any amount in excess of this might be treated as a windfall or extra cushion. By choosing to participate in DROP, employees may be saying that they are locking in the annuity they planned on and converting the extra cushion into a lump-sum form of payout.

Other designs that provide a partial lump-sum payout might not provide the same level of annuity income on which the employee planned. For example, a PLOP, where the employee gets a reduced annuity at NRA in exchange for a lump sum equal to their contributions would not accomplish the same result.

Employees might delay joining a DROP if they have a large pay raise they want factored into their final average salary before their annuity is frozen.

Specific plan design issues can be a factor. One plan required employees to be in the DROP for at least three years before becoming entitled to DROP benefits (i.e., if the employee retired after being in the DROP for less than three years they got a non-DROP benefit offset by missed employee contributions). This design was less popular among police officers than firefighters since many police did not want to make that commitment to stay at least three years beyond their NRD to get a DROP lump sum. Similarly a plan that requires mandatory retirement at the end of the DROP period might cause some employees to delay entry into the DROP.

If a member who has reached his maximum accrual rate (e.g., 70% of final average salary after 30 years of service) can elect the DROP, the choice is an easy one, and the DROP ratio can be expected to be high.

Many DROPs require employee contributions to stop at the beginning of the DROP participation period. This will increase take-home pay and can be a factor.

6.3 How Lump Sum Money is Used

Common discussions between retirees and investment advisors include:

1. Rollover to an IRA
2. Seed money to start up a business
3. Buying a boat or a car
4. Paying off a mortgage
5. Paying for a child's college cost

Under the Baltimore City DROP, fire and police employees have options with their DROP lump sums that include:(1) taking a lump sum and paying the income tax immediately, (2) rolling over the lump sum to an IRA or (3) buying an annuity from the plan. Most firefighters tend to retire in their 50s and are more likely to roll over the lump sum than are police officers.

Because of the pressure of their jobs, police officers usually retire in their 40s if they are eligible and are more likely to elect the annuity option or to take cash. Differences seem to be related to both age at retirement and a lower level of trust by police officers in either investment advisors or the stock market.

Some participants might initially roll over their DROP lump sum into an IRA but then follow one of the following withdrawal approaches:

- Some employees withdraw the IRA money over two or more tax years to avoid ending up in a higher tax bracket. Care should be taken if termination of employment is between age 55 and 59.5. The 10% tax penalty could have been avoided on money taken directly out of the plan (and not rolled over) at time of retirement.

- Some employees wait a year or so to see what their cash needs are after retirement. They then begin to take level annual payments from their IRA in a fashion designed to avoid the 10% penalty even if they are not yet age 59½. See IRS Revenue Ruling 2002-62 for more details on methods to avoid the 10% penalty.

Many of the issues involving lump sum vs. annuity payout in DB plans exist with DROPs including: tax issues, investment risks and mortality risks. Common discussions when designing a DROP include whether to allow alternate payout forms for the DROP lump sum. While an annuity payout has some logic it begs the question of why the member elected DROP; and if the DROP was to be cost neutral (by some definition), doesn't offering an annuity question why a DROP is offered? Perhaps the DROP could provide a better death benefit or some other type of enhanced annuity.