

## DROP Update: The Latest Variations on a Popular Theme

Public sector retirement plans have used DROPs — the acronym for deferred or delayed retirement option plans — for a variety of reasons, including managing workforce issues, such as the timing of retirement or providing competitive benefits; offering benefit flexibility to plan participants; and reducing the required contributions for their pension plans. Retirement plans for police and firefighters, which tend to have earlier normal retirement requirements (and correspondingly greater contribution requirements) with many participants electing early retirement, pioneered this plan design feature. DROPs, which may be used to manage critical workforce shortages, are also starting to gain popularity in teacher retirement plans as jurisdictions find it difficult to replace qualified teachers quickly enough to cover all those now eligible to retire. This *Public Sector Letter* focuses on the latest DROP designs.

### BACKGROUND: OVERVIEW OF TRADITIONAL DROPs

A traditional or forward DROP requires an employee to decide whether to elect to participate in the DROP at the time he or she becomes eligible for retirement. At the time of the DROP election (known as “entering the DROP”), the employee actually moves from being an active participant who is accruing benefits to being considered in retirement status (for pension purposes only). A monthly retirement benefit amount is determined based on current salary, service and age. During the DROP period, the employee continues to work and receive compensation,

but not service credit, while the entire monthly retirement benefit the individual would have received, or a portion of it, is allocated to a DROP account. Assets in this account earn interest at a rate defined under the plan’s provisions. The DROP may be designed with or without continued contributions based on the employee’s salary.

In a forward DROP, the election is usually irrevocable, requires cessation of employment at the end of the DROP period (usually one to five years) and results in a lump-sum benefit. The interest earned on the account may be a fixed percentage or a variable amount depending upon some index, or in some cases, based on the investment options selected by the employee. Some DROP designs allow participating employees to make additional contributions to their DROP accounts. When the employee terminates employment at the end of the DROP period,<sup>\*</sup> the retirement benefit

\* If a DROP participant actually terminates service prior to the end of the DROP period, the plan will have specific provisions as to how the accumulated DROP account is treated and when payment can be made from the account.

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is then paid directly to him or her and the balance in the DROP account can be distributed or rolled over according to plan rules.

Table 1 illustrates how one participant’s retirement benefits would differ if a forward DROP were elected instead of retirement at first eligibility (*i.e.*, age 55 in this sample plan). In this example, the tradeoff for receiving a lump sum of \$97,511 from a DROP

**TABLE 1: A COMPARISON OF RETIREMENT BENEFITS WITHOUT OR WITH ELECTION OF A THREE-YEAR FORWARD DROP BY AN INDIVIDUAL ELIGIBLE FOR EARLY RETIREMENT**

Sample Participant Information		No DROP Election	Forward DROP Election Example	
Age	Service	Projected Monthly Retirement Benefit <sup>1</sup>	Projected Monthly Retirement Benefit <sup>2</sup>	Lump-Sum Amount from the DROP Account
55	25	\$2,428	N/A <sup>3</sup>	N/A <sup>3</sup>
56	26	\$2,601	N/A <sup>3</sup>	N/A <sup>3</sup>
57	27	\$2,782	N/A <sup>3</sup>	N/A <sup>3</sup>
58	28	\$2,971	\$2,428 <sup>4</sup>	\$97,511
59	29	\$3,170	\$2,601 <sup>5</sup>	\$104,454
60	30	\$3,378	\$2,782 <sup>6</sup>	\$111,726

<sup>1</sup> This plan does not have a cost-of-living adjustment (COLA).

<sup>2</sup> This is the same as the amount of the monthly benefit accumulating in the DROP account each year.

<sup>3</sup> “N/A” = benefits not available during the DROP period. Because this plan offers a three-year forward DROP, if the individual wants to elect the DROP at age 55, he or she cannot retire before age 58.

<sup>4</sup> This benefit assumes the DROP was elected at age 55.

<sup>5</sup> This benefit assumes the DROP was elected at age 56.

<sup>6</sup> This benefit assumes the DROP was elected at age 57.

Source: The Segal Company, 2004.

account at age 58 will be a lower monthly retirement benefit than if he or she had opted for early retirement at age 55.

**THE LATEST INNOVATIONS IN DROP DESIGN**

Since the implementation of the first DROPs in the 1980s, a number of variations have been developed by plan sponsors to fit their particular needs. These include:

- Immediate DROPs, which are also known as partial lump-sum (PLUS) payout options or partial lump-sum option payouts (PLOPs),
- Retroactive or back DROPs, and
- DROPs with optional features.

**PLOPs**

Under a PLOP, no prior election to participate in the DROP is necessary. At the time of retirement, the participant may choose a percentage reduction in his or her monthly benefit amount and a partial lump-sum amount. If the participant elects a reduced monthly benefit, he or she begins receiving the reduced monthly benefit amount immediately, as well as the lump sum that represents the actuarial value of the benefit reduction amount. Making the eligibility requirements for the PLOP different from the eligibility provisions for regular retirement can influence the timing of an individual’s retirement.

**Retroactive DROPs**

Retroactive DROPs and PLOPs are similar. Under both, the employee continues working past the earliest retirement age under the plan and is not required to elect into the deferred retirement option until actual retirement. Also, in both designs, the value of the monthly benefit and the amount of the lump sum are known.

When an employee elects to receive benefits under a retroactive, or back, DROP plan, the employee’s monthly

**TABLE 2: A COMPARISON OF RETIREMENT BENEFITS FROM A PLOP AND A RETROACTIVE DROP BY AN INDIVIDUAL ELIGIBLE FOR EARLY RETIREMENT**

Sample Participant Information		No PLOP or Retroactive DROP Election	Possible PLOP Election		Possible Retroactive DROP Election <sup>1</sup>	
			25 Percent Reduced Monthly Benefit	Lump-Sum Amount from the DROP Account	Reduced Monthly Benefit	Lump-Sum Amount from the DROP Account
Age	Service	Projected Monthly Retirement Benefit				
55	25	\$2,428	\$1,821	\$108,491	N/A <sup>2</sup>	N/A <sup>2</sup>
56	26	\$2,601	\$1,951	\$114,132	N/A <sup>2</sup>	N/A <sup>2</sup>
57	27	\$2,782	\$2,086	\$119,780	N/A <sup>2</sup>	N/A <sup>2</sup>
58	28	\$2,971	\$2,229	\$125,417	\$2,428 <sup>3</sup>	\$97,511
59	29	\$3,170	\$2,377	\$131,021	\$2,601 <sup>4</sup>	\$104,454
60	30	\$3,378	\$2,533	\$136,570	\$2,782 <sup>5</sup>	\$111,726

<sup>1</sup> The reduced monthly benefit amount and the lump-sum amount from the retroactive DROP are the same as the reduced monthly benefit amount and the lump-sum amount from the forward DROP illustrated in Table 1 because the primary difference between these two DROPs is the timing of the DROP election.  
<sup>2</sup> "N/A" = benefits not available during the DROP period. This retroactive DROP design does not allow elections until three years after the participant first becomes eligible for early retirement.  
<sup>3</sup> This benefit assumes the DROP was retroactive to age 55.  
<sup>4</sup> This benefit assumes the DROP was retroactive to age 56.  
<sup>5</sup> This benefit assumes the DROP was retroactive to age 57.

Source: The Segal Company, 2004.

benefit is calculated as if the employee had entered the DROP at the time he or she first became eligible for retirement benefits. The employee receives this reduced monthly benefit amount along with a lump sum equal to the monthly benefit amount times the number of months since earliest retirement age — usually with a defined interest credit. Under a retroactive DROP, the employee receives the same monthly benefit and lump-sum amount as under a forward DROP but does not have to make an irrevocable election prior to actually retiring.

The key difference between retroactive DROPs and PLOPs is that under the retroactive DROP the lump sum is an accumulation of the monthly benefits that would have been paid to the participant had he or she retired early, whereas the PLOP is typically designed to be cost-neutral because it is actuarially equivalent to the annuity that the participant would have received, calculated as of the date of retirement.

Both retroactive DROPs and PLOPs have some advantages over forward DROPs, including greater flexibility,

easier administration and lack of adverse selection by employees, since election occurs at actual retirement. Table 2 compares the retirement benefits from a PLOP and a retroactive DROP.

**Optional DROP Features**

One optional DROP feature is called a decreasing DROP period. For example, if a DROP allows entry at 25 years of service and a maximum DROP period of five years, for every year an employee works past 25 years, the allowable DROP period is reduced by one year. The purpose of a decreasing DROP period is to encourage early retirement, rather than to retain experienced employees, which traditional DROPs were initially intended to do. In addition, plans may offer DROP windows that, similar to early retirement windows, allow only employees who meet prescribed eligibility criteria to irrevocably elect a DROP during a limited period of time. Further, some plans treat DROPs like a defined contribution account by allowing employees to direct the investment of DROP account accumulations or take a loan against DROP account amounts.

### ADVANTAGES AND DISADVANTAGES FOR EMPLOYERS

A major reason for employers to implement DROPs is to influence employee behavior. DROPs can be used to retain experienced employees who are eligible to retire, but who cannot yet be replaced with existing employees. This is an especially important goal for employers at a time when the baby boom generation is preparing to retire in large numbers. DROPs may be used to counter the effects of early retirement incentives. Alternatively, PLOPs and back DROPs can be used to reduce employment levels if desired by the employer, allowing employees to take advantage of early retirement subsidies or incentives by providing additional income during the early years of retirement to bridge the gap between employment income and Social Security retirement or Medicare eligibility.

Employers should be aware that the DROP designs might cause adverse selection. That is, an employer may find that the design provides the greatest enticement for employees who do not fit the target profile. For example, a DROP may encourage end-of-career employees to stay even longer when the employer really needs to encourage most of those employees to leave and create openings for promotion. A DROP must be carefully designed to be consistent with clearly established goals.

### ADVANTAGES AND DISADVANTAGES FROM THE EMPLOYEE'S PERSPECTIVE

DROP programs are popular with employees for a number of reasons. One major factor is that DROPs combine the flexibility of a defined contribution plan with the security of a defined benefit plan. DROP participants can give their retirement a jump-start, using the lump-sum amount to pay off debt, make a large purchase or invest the amount for future financial needs. At the same time,

the participant is still guaranteed to receive monthly retirement income for life, albeit a benefit reduced by the lump-sum DROP distribution.

In addition, DROPs can be used to reallocate pension income to the early retirement years to supplement retirement income prior to Social Security and Medicare eligibility. Alternatively, since DROP accounts are eligible for rollover to an individual retirement account, employees can use DROPs to defer taxable income to later years if this is desirable.

Another major reason DROPs are popular with employees is that DROPs are often designed to allow employees to receive the benefit of early retirement subsidies in the plan without leaving employment. A DROP may also allow an employee who has reached the maximum service counted under the plan's benefit formula to continue working without any loss of pension benefits.

In making DROP elections, employees should be aware of the risk of the DROP election resulting in a less valuable benefit. Often, employees who are not likely to benefit from a DROP still elect one because they are unaware of the benefit implications or because they place a high value on receiving a lump sum. For example, employees should consider whether their earnings are likely to increase significantly during the DROP period, because such future earnings increases will not be taken into account under the defined benefit formula, resulting in a lower monthly retirement

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benefit. In addition, employees should consider the impact of foregoing benefit formula improvements and perhaps retiree cost-of-living increases during the DROP period. These issues are mitigated when the plan offers a PLOP or back DROP, since the employee does not have to make a decision until actual retirement.

### THE QUEST FOR COST NEUTRALITY

A key consideration for plans in designing a DROP is the impact to the funding requirements of the plan. Many DROP programs are intended to be “actuarially cost-neutral.” If a DROP were offered to all employees as an actuarially equivalent option to an existing retirement program, then there would appear to be no cost impact to the plan. However, true actuarial cost can only be measured with the actual experience of the plan in relation to its assumptions.

For example, if a DROP program causes employees to retire earlier than they would otherwise, the employer's long-term cost of funding the plan increases. This is because pension benefits must be funded over a shorter period of time and paid over a longer period. The cost impact of a DROP is further increased where the plan subsidizes early retirement. This is because employees who work past early retirement age (not wanting to forego current wage income) provide an actuarial gain to the plan each year that they continue to work rather than receive retirement benefits. However, under a DROP, the employee can continue receiving wages and still take advantage of the early retirement subsidy, eliminating this actuarial gain. In order to minimize increased funding costs, plans may allow DROP elections only at a specified retirement age under the plan.

There are a number of DROP designs that plans use in order to control the utilization rate and therefore the cost

of a DROP. One such plan design is to deposit into the DROP account an amount that is less than 100 percent of the monthly benefit calculated at the time of the DROP election. This design retains the difference to offset costs. Another way plans can control the financial impact of a DROP is to control the amount of interest earnings.

DROPs with cost-neutral designs often include features that limit benefit payments and make the DROP election less attractive. In addition, plan sponsors must take into consideration the costs and administrative burden of implementing a DROP.

**LEGAL ISSUES**

In addition to cost considerations, there are a number of potential legal issues that plans should be aware of with regard to DROP programs. For example, if the interest credited to a DROP account is based on actual earnings, rather than a fixed rate, the DROP benefit may be treated as a separate defined contribution plan subject to the limitations set forth in Section 415(c) of the Internal Revenue Code. If the DROP allows for an interest rate that is subject to discretion by the plan sponsor, an issue may be raised as to whether benefits under the plan are definitely determinable, which could trigger questions about plan qualification. DROPs with maximum age restrictions may have implications under age discrimination laws. Lump-sum distributions prior to age 55 are subject to a 10 percent penalty. The Segal Company strongly urges plan sponsors to seek the advice of legal counsel when dealing with these complex legal issues.

**POLICY ISSUES**

Before introducing a DROP, the retirement plan sponsor should consider the following policy issues:

➤ *Would a DROP support benefit and workforce objectives?* For example, depending on the design,

DROPs can support an employer’s efforts to encourage or discourage early retirement.

➤ *Would a DROP be consistent with or contradictory to other benefit programs?* How a DROP will interact with retiree medical benefits and existing disability benefit and disability income programs are important considerations. DROPs can also bridge the income gap for early retirees until they start to receive Social Security benefits.

➤ *How will the plan monitor future amendments and their impact on the DROP?* For example, if the plan sponsor wishes to implement an early retirement window, will employees who have exercised a DROP election — but not yet retired — be offered the window? Other benefit changes, either in the pension plan or in another plan, may have an impact on expected DROP participation in future years. Therefore, policy and/or benefit changes must be considered in setting the assumptions used to value the pension plan including the DROP option.

➤ *What retirement benefits are realistic?* For public sector entities, retirement benefits are subject to scrutiny by taxpayers. The employer needs to consider whether addition of DROP benefits is a valid use of taxpayer dollars.

**CONCLUSION**

Implementing a DROP program requires careful consideration of many factors. However, once an employer has made the effort to design a DROP with clearly defined goals that are consistent with the makeup of its desired participation group and current plan, the DROP can support and augment human resources initiatives.

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