



*addressing public pension issues of today  
...AND TOMORROW*

## Public Safety Employees Pension & Benefits Conference

Public Perceptions of DROP and  
Public Safety Pensions: Problems  
& Solutions

# DROP – Deferred Retirement Option Programs

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A much maligned, but valuable and beneficial tool

IF

Cautiously & properly designed and managed

# Overview – Where are we going?

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1. Sources & Case Studies of Negative Publicity
2. Cost Pitfalls and Other Problems with DROP
3. “Golden Rules” of DROP Design
4. Addressing the Cost-Neutrality Dilemma
5. Public Perception of DROP
6. Benefits of DROP
7. Positive Case Study

# Sources & Case Studies of Negative Publicity

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- n Unfortunately, DROP has had some negative publicity:
  - n Quote from front-page NYT article (by Mary Williams Walsh)
    - n “DROP’s have been abused again and again by naïve or self-interested officials, who have pumped up benefits well beyond what the rank and file expected or what the pension fund could pay.” - Ouch
- n Case Studies – what went wrong?
  - n Milwaukee
  - n Houston
  - n San Diego

# Sources & Case Studies of Negative Publicity

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## n Milwaukee

- n Felony conviction for Personnel Director for stating in memo that DROP would be cost neutral
- n Back-DROP
  - n What is a Back DROP?
- n Even worse, unlimited Back DROP
- n High interest rate credit (9.0%!?!)
- n Large lump sums (PR problem)
- n Non-safety employees
- n Bad assumptions (low participation assumption compounds impact of cost underestimation)

# Sources & Case Studies of Negative Publicity

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## n Houston

- n High interest rate credit (8.5%)
- n Large lump sums (PR problem)
- n Non-safety employees
- n Cash flow crunch
- n Low DROP participation assumption compounds cost underestimation

## n San Diego

- n Attention on DROP magnified by increased focus on pension system because of other funding problems
- n Similar problems as Houston (high interest – 8%, non-safety, large lumps sums, etc.)
- n Likely that DROP will be dropped

# Cost Pitfalls and Other Problems with DROP

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- n What do these and other problematic DROPs have in common?

- n High Interest Rate Credits

- n Under DROP, rather than reasonable, low

- § Have seen proposed DROP where interest = higher of plan return or 8%, when assumed plan return was only 7.25%

- n Under DROP, plan responsible for financial risk while DROP deposits being made, unlike regular annuity benefit paid to participant

# Cost Pitfalls and Other Problems with DROP

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- n Enable participants to elect against the soundness of the Plan – Antiselection
  - n “BackDROPs, etc.”
- n DROP length
  - n Long maximum and/or minimum DROP periods (or even unlimited) can generate massive lump sums. This can create bad PR, even if the DROP is otherwise well-designed and lengthy period of DROP more effective in extending service, which is potential benefit to jurisdiction

# Cost Pitfalls and Other Problems with DROP

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- n Final Average Salary issues
  - n Spiking of salaries (through overtime, sick leave, longevity) at end of career can create larger than expected benefits
  - n DROP doesn't create the issue, but can magnify in public's eye through large lump sums
- n Payroll Issues
  - n Impact on payroll from longer-service employees can exceed impact on pension plan

# Cost Pitfalls and Other Problems with DROP

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- n Promotional Opportunity Issues
  - n Less senior employees have expressed dismay at fewer promotional opportunities caused by extended senior service from DROP
- n Negative investment return could hurt employees
- n Makes life hard for Actuaries!
  - n Just kidding (sort of)
  - n Complicates plan, assumptions
  - n Make sure your actuaries are using reasonable assumptions to value DROP plans
  - n May be advisable or necessary for actuary to provide range of possible costs rather than fixed cost estimate

# “Golden Rules” of DROP Design

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- n Safety Employees Only!
  - n General EE's can have extremely high paid individuals who would get huge lump sums
  - n Different demographic concerns for General EE's - DROP not necessarily best solution
- n Use Conservative Interest Credit
  - n Could use credit tied to bond returns
  - n Or, use fixed rate lower than assumed return on assets
- n Avoid antiselection (such as “BackDROP”)
- n Avoid extremely long DROP periods
  - n Eliminates large lump sums and associated PR problems

# Addressing the Cost-Neutrality Dilemma

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- n Why is it difficult to make DROP cost neutral?
  - n By their nature, DROPs represent a preservation of early retirement subsidies (implicit in 20&Out or 25&Out retirements) for those who choose to continue working
  - n Therefore, adding DROP (without offsetting provisions) normally results in cost increase, unless:
    - n Everyone currently retires when first eligible (not typical, esp. for fire), or
    - n Presence of large late-career pay raises or benefit accruals

# Addressing the Cost-Neutrality Dilemma

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- n If cost-neutrality desired, can use offsetting provisions to counteract effect of employer subsidy preservation
  - n Using low(er) interest rate credits
  - n Use partial DROP benefit credits
    - n DROP credit < 100% of retirement benefit
  - n Forego COLAs during DROP
  - n No disability or survivorship type death benefit during DROP
  - n Higher employee contributions due to shorter funding period

# Addressing the Cost-Neutrality Dilemma

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- n Finally, even if DROP projected to be cost-neutral, no guarantee that it will be in actuality
  - n Again, may be advisable for actuary to provide range of potential costs, instead of implying anticipated cost-neutrality
- n Favorite quote about actuaries – “We’re always wrong”
  - n Actual cost determined by actual experience, projected cost based on uncertain assumptions about future
- n Even if DROP is actually cost neutral, virtually impossible to verify this after the fact

# Public Perception of DROP

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- n What is the Public Perception as to why DROP should not be offered?
  - n We lowered the retirement age based on the complaint that safety members should not be required or encouraged to work past 45-50 in a job which required vigorous and youthful service delivery
  - n DROP encourages these members to stay on by preserving the early retirement subsidies to later ages

# Public Perception of DROP

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## n Other Issues

### n Large lump sums

- n Especially when private sector employees have seen 401(k) balances battered

### n “Double-Dipping”

- n Must explain clearly that benefits have already been earned – would have been paid anyway if employee had retired
- n “Triple-dipping” – some jurisdictions have had to rehire post-DROP retirees because of lack of qualified replacements

### n Public Officials designing own benefits

- n Help avoid this by making DROP safety-only

# Benefits of DROP

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- n Why is DROP desirable to the public jurisdiction?
  - n Need to communicate this effectively
  - n Enables Jurisdiction to keep senior/key employees without enabling higher salaries to be pensionable
  - n Save on training, retiree medical, and other costs
  - n Efficiency/Productivity of experienced employees
  - n Sparcity of new hires

# Benefits of DROP

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- n Can potentially have cost savings, if ...
  - n Conservative design (interest rate, % of benefit, etc),
  - n Current benefit has high back-loading characteristics, such as large, late pay raises, or
  - n Lower disability costs
    - n Can have lower costs if currently experiencing high disability rates near NRA
    - n Replace disability benefits with DROP
    - n Still ensure adequate benefit for members who become disabled late in career

# Positive Case Study - Dallas

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- n DROP plan put in place in 1993
  - n Unlimited forward DROP
  - n Five-year follow-up study in 1997
    - n Actuary says basically cost-neutral (maybe even cost-savings)
    - n Average retirement age increased (from 52.4 to 57.7)
    - n Material decline in disabilities
    - n DROP participation rate almost 100%
    - n Some concern from younger members regarding promotional opportunities

# Conclusions – Where have we been?

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