Deferred Retirement Option Program

Initial Consideration

Washington State Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board

July 26, 2006

Brief Summary

- Background and History
- DROP Basics
- DROP Design Choices
- Opportunities and Challenges

Background and History

- **D**eferred **R**etirement **O**ption **P**rogram
- 1981 East Baton Rouge Parish, Louisiana
  - Covered Police, Fire, and Public Employees
  - Followed by State Police and State Fire Fighters' plan (1984)
- Purpose - Employee Retention

Background and History

- Few drops started in 1980
- Spread materially in mid-1990’s and limited to public safety
- Emerging design/cost problems slowed use

DROP Basics

- Retirement eligible member voluntarily commits to the DROP
- Member continues to work
  - “Retire now, stop working later”
- Retirement benefit amount frozen
  (no more increases for service or salary)

DROP Basics

- While working, the monthly retirement benefits accumulate in a DROP account
- Lump sum (DROP account balance) paid to member after separation from employment
- Member begins receiving monthly benefit

DROP Design Choices

- Size of credits to DROP account
- Interest on DROP account
- Eligibility Requirements
- DROP window (end of eligibility)
- DROP period
- Do contributions stop (EE and/or ER)?

DROP Design Choices

- Are COLAs credit during DROP?
- Distribution options (lump sum or spread out)
- Provisions for working after DROP
- Death and disability benefits
- Ability to revoke decision

Opportunities

- Accomplish employer goals
  - Retain valuable employees, or
  - Encourage retirement
- Response to employee demand
  - Large lump sums are attractive benefit
- Increase employee retirement savings

Challenges

- Creating a cost-neutral plan
  - Members tend to desire more valuable plan
  - Predicting change in retirement behavior
- Members stop increasing benefit too soon
- Complex and costly administration
- Negative Publicity

Deferred Retirement Option Program

Questions?

Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board

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July 26, 2006

1. Issue

The Board requested a briefing on Deferred Retirement Option Programs (DROP).

2. Staff

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3. Members Impacted

As of September 30, 2004 there were 14,754 active members and 432 retirees as reported in The Office of the State Actuary's 2004 LEOFF 2 Actuarial Valuation Report.

4. Current Situation

A LEOFF Plan 2 member can retire for service with a full benefit at age 53 with 5 years of service, or with an actuarially reduced benefit at age 50 with 20 years of service. LEOFF Plan 2 does not currently contain any DROP provisions.

5. Background Information and Policy Issues

DROP stands for Deferred Retirement Option Program (Plan is commonly used instead of Program). A DROP is a defined benefit (DB) plan design feature that started in the 1980's, grew in popularity during the 1990's, and decreased in popularity at the end of that decade.

The first DROP began in East Baton Rouge Parish in 1981 and covered all groups of employees (police, fire and general employees). The stated purpose of the original DROP plans was to encourage law enforcement officers and fire fighters to work past their normal retirement date. Commonly noted, this purpose is contradictory to the early normal retirements that are typically available in public safety retirement systems today.

Around 1984 a DROP feature was added to the Louisiana Municipal State Police plan and then to the state firefighters' plan. Although there were a few other DROPs started during the 1980s, DROPs began to spread in a material fashion beginning in the mid-1990s. Many of these early DROP plans were limited to public safety employees. Widespread use in public retirement systems stagnated due to emerging design and cost problems in the early DROPs.

DROP Basics

A DROP allows a member to continue to work beyond their normal retirement age and convert the value of part or all of the retirement benefit into a lump sum. The lump sum is typically defined as the accumulation of the monthly benefit the member would have been entitled to receive at the normal retirement age.

The typical DROP allows the employee to have their retirement benefit calculated at the time the DROP is elected and establish an account for the sole purpose of accumulating benefits during the DROP period. During the DROP period, the employee's DROP account would be credited with all or a portion of the monthly retirement benefit, rather than the benefit being paid directly to the member.

Depending on the features of the DROP, the account may also be credited with interest or cost of living adjustments (COLAs). The DROP account is then paid to the member at the time of separation from employment, and the member's monthly retirement benefit (as calculated at the beginning of the DROP period, ignoring any service credit or pay increases during the DROP period) commences being paid directly to the member. The next section discusses several of the features commonly considered in the design of a DROP.

DROP Plan Design

The features of DROPs vary widely and have a significant impact on both the attractiveness and cost of the plan. As with any benefit improvement, the more features added the more attractive the improvement is for members. However, the addition of attractive features may increase the costs of the plan. Is possible however to use some features to help contain costs.

The typical design of a DROP allows the option to be exercised only when a member is eligible for normal retirement. DROP periods in such plans are typically for one to five years in length. When a member chooses a DROP option, the member continues to work for the covered employer. Once the DROP period begins, the monthly benefit that the member is eligible to receive goes into an account rather than to the member. At the end of the DROP period, most DROP plans pay the lump sum of the account to the member, but some plans permit a roll-over into an IRA or similar tax-deferred account. Below is a list of some of the features often considered in DROP plans:

- Some DROP plans permit the account to earn interest.
- Some plans do not provide disability or death benefits during the DROP participation period.
- Some DROP plans allow for the employee contributions into the system to cease.
- Some DROP plans require the employer to continue to pay employer contributions or a portion of contributions.
- Most DROP plans fix the amount of the monthly benefit to be paid to the member without recalculation at the end of the DROP period. The member in most plans does not earn additional years of service credit nor does the member get the benefit of salary increases during the DROP period.
- Some DROP plans permit COLAs to be credited to the DROP account.
- Most DROP plans require the decision to enter the DROP to be irrevocable and also require the member to actually leave employment at the end of the DROP period.
- Most DROP plans permit the member to retire before the end of the DROP period; however a penalty of some kind is sometimes applied.
- Some DROP plans permit the member to purchase an annuity from the system.
- Some DROP plans permit the funds to stay on deposit for as long as the member wishes while others require payment to be made immediately upon separation from employment.

In 2003 Tom Lowman of Bolton Partners prepared a report for the Society of Actuaries titled "Design and Actuarial Aspects of Deferred Retirement Option Programs". This report included a detailed discussion of several of the DROP features listed above which can be found in Appendix A: Drop Design Features.

The report also included a survey of basic design features of DROPs in twenty-four different public-sector plans in the United States. Additionally, the report included a summary of thirty-eight DROP plans in the state of Texas. Appendix B provides a summary of the information from the twenty-four public sector plans and the thirty-eight Texas plans.

Cost Issues

National pension expert Carol Calhoun published an article titled “Deferred Retirement Option Plans” which outlined several cost considerations of DROP plans. The article recognized that cost of a DROP plan must be considered as part of the “give and take” for determining benefits (vs. services provided) between the employers and employees in order for the DROP to be successful. Below is several of the cost issues identified which should be examined when considering a DROP.

Many DROP programs strive to be "actuarially neutral." If a DROP Plan is provided as an overlay to the existing retirement program as an actuarially equivalent option, offered to everyone, then there should be no direct cost for the program. However, increases in pension benefits above those currently provided cost more money. As retirement programs are generally funded over the working lifetime of the members, actuarial costs are only truly measured with experience.

Beyond the costs generated by the DROP plan features themselves, additional cost may occur if the design of the plan causes a change in retirement behavior. When an employee who is eligible for retirement benefit decides to continue to work longer than expected, the pension plan experiences an actuarial gain since it does not provide the pension payments for that period. The longer the employee continues to work, the larger the actuarial gain to the plan. These actuarial gains serve to lower the ongoing cost of the plan.

But examine what happens with the addition of a DROP program changes behavior toward earlier retirement. From the pension plan's viewpoint, when an employee chooses the DROP option, it is exactly as if the employee has retired since actual pension payments will begin. When an employee retires earlier than expected , the pension plan experiences an actuarial loss since it has to provide pension payments for a period longer than expected.

If the pattern of incidence of retirement changes under the DROP, then from an actuarial standpoint, the assumptions concerning when members will retire may need to be revised down to take this actual experience into consideration. Using lower assumed retirement ages may result in higher required contributions to properly keep the plan in balance.

Most government plans mandate employee contributions which are used to offset the cost of the plan. Design choices regarding these contributions can affect the ongoing cost of the retirement program. If the employee contributions continue during the DROP option period, the cost continues to be offset. But, if the employee contribution ceases at DROP choice or is also deposited into the DROP account, then the total cost portion normally funded by the employee must come from the plan. Likewise, if the employer contributions to the plan cease, the cost normally funded by these contributions must also be funded by the plan. In either case, less contributions into the plan also means fewer assets to earn investment returns.

In preparing cost calculations, it is assumed that assets will earn a stated investment return. To the extent that the plan assets earn a rate higher than that assumed by the actuary, the fund experiences an actuarial investment gain which may serve to lower contribution rates. However, if a lower than assumed rate is earned it may serve to increase contribution rates. Similarly, if a plan credits interest to DROP accounts at a rate that exceeds actual earnings, the plan will be required to pay for the difference between these rates reducing the assets of the plan and possibly requiring an increase in contribution rates.

Legal Issues

If a DROP plan is adopted it must be “definitely determinable” to meet IRS requirements for a qualified plan. This requires the DROP to be available for all plan participants. For example, if a retirement system wanted to give a DROP option only to a certain limited group of members to encourage this group to work longer, it could not be done consistent with the Internal Revenue Code (IRC).

“Definitely determinable” also means that there must also be a consistent formula to determine the DROP benefits. Many tax attorneys believe that if a DROP plan earns market rates of return without a fixed rate, index or formula, that a DROP plan could be deemed to be a separate defined contribution plan on top of a defined benefit plan. Such a design would make DROP plans unattractive since such a plan would be subject to §415(c) IRC limiting the amount of compensation per year that could be deposited. The Internal Revenue Code has certain income limits for retirees under §415(b). Different limits apply to public safety personnel at different ages to reflect their usual earlier normal retirement age. Amounts paid from a DROP account must be considered in these limits.

DROPs in the News

As previously mentioned, the spread of DROPs has slowed due to emerging problems with DROP plan designs. Retirement systems that had created DROPs were largely experiencing that DROPs had costs that had not been accounted for when the plans were designed. The experience of these plans has been critically watched in the press. Several examples DROP plans that have received publicity are provided below.

Governing Magazine published an article in September 2004 on DROP plans entitled “DROP OUTS: a seemingly simple device to keep retirement-age workers on the job is turning into a pension plan debacle.” The article chronicled many of the high-profile problems with DROP plans around the country. One of the conclusions of the article was, “[w]hatever your view of DROPs, there is one sure thing about them: They are a public relations grenade waiting to explode. When the fire commissioner leaves office with half a million dollars in his pocket…the press is sure to get inflamed about it.” Similar conclusions were expressed by officials in a 2002 Milwaukee Journal Sentinel article which examined DROP plans around the country (see Appendix C to read a copy of the article).

An article in the May 17, 2004 edition of *Fortune* entitled “The $366 Billion Outrage” focused on the DROP plan of the City of San Diego. Along with a defined benefit formula that contains a 2.5% multiplier, the system provided a DROP with a guaranteed 8% interest rate on DROP accounts. The Mayor of San Diego was quoted in a local San Diego paper as advocating the elimination of the DROP plan and attributed part of the systems $1.1 billion unfunded liability to the DROP plan.

The City of Houston system was also mentioned in the *Fortune* article. The Houston plan offered a guaranteed floor of 8.5% interest on DROP balances with the prospect of getting more if investment earnings were higher resulting in financial difficulties for the system.

The State of South Carolina instituted a program called the “Teacher and Employee Retirement Incentive” (TERI) which was aimed at retaining teachers and “key employees”. The plan was structured as a forward DROP, but was only available to “key employees”. A study of TERI found that it increased the unfunded liability of the retirement system by $100 million. The IRS advised that if the plan continued it would have to be available to all employees. There were complaints that the program had the effect of keeping non-productive employees on the payroll longer, employees around who could otherwise retire, and not promoting less-experienced employees who were ready for promotion.

6. Supporting Information

Resources

Carol V. Calhoun, Calhoun Law Group PC, “Deferred Retirement Option Plans,” October 13, 1998

Tom Lowman, Bolton Partners Inc., “Design and Actuarial Aspects of Deferred Retirement Option Programs,” Published by Society of Actuaries, March 6, 2003.

John Garret, Milliman Inc., “Considering a Drop? A Plop May Fit Better”, February 2006, PERiScope.

Governing Magazine, September 2004

Appendices

Appendix A: Drop Design Features
Appendix B: Survey of DROP Designs
Appendix C: Milwaukee Journal Sentinel Article

Appendix A: Drop Design Features

Source: Tom Lowman, Bolton Partners Inc., "Design and Actuarial Aspects of Deferred Retirement Option Programs," Published by Society of Actuaries, March 6, 2003.

There are many design features to be considered in a DROP plan. Many variations of DROP features have been developed, many of which are driven by a desire to make the DROP cost neutral.

Participation Period:
The participation period refers to the time that a participant is covered by the DROP. Most plans have a maximum period of two to five years. The DROP plan in Dallas has no limit.

Interest Crediting Rate:
Common choices include the following:

1. Fixed interest rate
2. Rate tied to funding assumption
3. Rate tied to outside index
4. Rate tied to actual investment return
5. No-interest credits.

Many of these same choices are found in cash balance plans. The interest rate selected may have a limited impact on cost because it usually only applies for a limited number of years and to only part of the benefit and starts with a principal balance of $0. Lowering the interest rate can reduce the cost of a DROP but often not in a material way without almost totally eliminating interest credits (which is sometimes done). When selecting an interest basis the following points are often discussed:

1. The valuation assumption is often deemed to be cost neutral. However, a more sophisticated discussion will: (1) recognize the difference in duration between the fund as a whole and the DROP account and (2) question the appropriateness of crediting a return that likely includes a risk premium when the employee is not taking the investment risk.
2. Whether the rate is based on the valuation assumption or an outside index, the interest-crediting rate might be offset (e.g., reduced by 100 basis points) to provide the plan sponsor some "profit" or a basis to offset higher administrative cost.
3. Using the actual investment return raises issues about whether this is a DC plan or a DB plan. Both this feature and self-directed DROPs have these issues as do the few self-directed cash balance plans that currently exist. Also see Sections 5.1 and 5.4.

COLAs:
Some DROP designs include COLAs provided while an active DROP participant. This is done so that the DROP pays the same benefits that would have been paid had the participant retired (notwithstanding the additional employee contributions). However, in plans that provide automatic COLAs, permanently eliminating those increases that would be paid during the DROP participation period would significantly reduce the value of the benefit.

This is a common approach to consider making a DROP cost neutral even though from an employee perspective it appears that something is being taken away.

One alternative is to not credit the COLA during the DROP period, but once the DROP period has ended and the DROP lump sum has been established, the COLAs skipped during the DROP period can be credited to the annuity payment.

Employee Contributions:
Most public-sector plans require employee contributions. Some plans require employee contributions to continue during the DROP participation period while others require contributions to stop. Even if contributions continue, some plans consider them to be additions to the DROP lump sum account while others do not. The choice of whether to continue employee contributions may depend (but does not need to depend) on how the designers view DROP participants: active or retired. The impact on DROP cost can also influence this choice; i.e., to make the plan cost neutral, employee contributions may need to continue while not being added to the DROP lump sum account. However, if the choice is between discontinuing contributions and adding 100% of employee contributions to the DROP account, the cost impact is probably relatively small.

The decision to continue employee contributions may have to be a plan wide choice to preserve the pre-tax status of employee contributions (per Section 414(h) of the Internal Revenue Code).

Disability Benefits:
A typical “non-DROP” public-sector plan will provide a duty-related (service-connected) disability benefit of 50% or 66% of pay (tax-free) and a non-duty related taxable disability benefit equal to the accrued benefit. These benefits often apply even if the disability occurs after normal retirement. For public safety employees, the duty-related benefit is very important and may account for 10% to 30% of all retirements.

Some plans do not provide disability benefits during the DROP participation period. The choice of whether to provide a disability benefit may again depend (but does not need to depend) on how the designers view DROP participants: active or retired. As with other variables, the choice may also hinge on the impact on DROP cost (DROP periods often cover ages when disability rates are high).

Because of the tax-free nature of line-of-duty disability benefits in the public sector, disability benefits are often more valuable to the employee than a DROP retirement benefit. If the DROP employee is not offered disability benefits, there may be an ADEA concern since the DROP takes away the disability benefit from older employees. However, the employee will have made a voluntary election to join DROP. The plan administrator might want to point this out on the DROP election form.

Death Benefits:
Somewhat similar issues exist for death benefits. Each plan is different enough that some thought needs to be given as to what happens if the employee dies during the DROP participation period and when an employee elects the form of their retirement benefit.

Annuity and Pay-out Options:
Even though the DROP is designed to provide a lump sum, employees may want an annuity option. Based on informal discussions, this seems more common among police than fire employees. As long as this is done on an actuarially equivalent basis (including COLAs), this can be made a cost neutral feature of the DROP.

An even more common question is whether the DROP lump sum can be left in the plan after retirement to earn a relatively high fixed rate. Some DROP plans require the lump sum to be distributed while others require a distribution schedule if the money is left in the plan.

Eligibility:
Often a plan requires an employee to reach NRD before joining DROP. However, a plan might provide an NRD at the earlier of age 50 or attaining 20 years of service. It would not be uncommon to make the requirement 20 years of service, thus making an employee hired at age 40 wait until age 60 to join DROP. Public plans have more service portability than do private sector plans. As a result, consideration is often given to requiring that the minimum service required to elect DROP be with the plan sponsor.

Benefit Improvements:
The DROP can reflect benefit improvements in the overall plan. For instance, if the plan is amended to give all retirees a 10% increase in their monthly benefit (not as a COLA adjustment), the DROP participants may or may not have their DROP annuity increased. Similarly, plan design can address the situation in which DROP participants are considered “active” and benefits are improved for active participants. Whether DROP participants get “retiree” improvements or “active” improvements or neither or both could be addressed when the DROP is designed. However, any decision could probably also be overridden when the improvement is enacted.

Diet DROP:
A diet DROP is a DROP with a short participation period for just a few months before retirement. This may provide a lump sum large enough to pay off some bills without a material reduction in the annuity.

Phase-in of Coverage:
One possible consideration is to provide a phase-in of DROP coverage. When DROP is initially offered, there may be a large number of eligible employees. While only three percent of employees may become eligible to retire each year, there may be 15% already over NRA. The employer might not want all 15% to retire at the same time at the end of the initial DROP period.

Sunset Provisions:

A sunset provision in a DROP allows the sponsors to evaluate the DROP after a specified time period and either renew the DROP, modify the provisions or terminate it. This provision can allow sponsors a partial way out if the DROP cost has turned out to be much higher than expected. DROPs have been in existence since the 1980s, but only in the last few years has there been a large increase in their popularity. Because of tax and cost uncertainty it was not uncommon that DROPs were adopted on a trial basis. Many public plans contain a “contract clause” that prevents the employer from negatively changing the terms of the plan for existing members. Adding a sunset provision is a way some employers have carved the DROP out of the contract clause.

Appendix B: Survey of Drop Designs

Source: Tom Lowman, Bolton Partners Inc., "Design and Actuarial Aspects of Deferred Retirement Option Programs," Published by Society of Actuaries, March 6, 2003.

	U.S. Survey	Texas Survey
Number of Plans	24	38
Number of forward DROPs	22	16
Number of back DROPs	3 (1 can be both Forward and Back)	27 (5 can be both Forward and Back)
Number of fire plans	11	32
Number of police plans	11	4
Number of general employees/teachers	10	4
Number with 24-month max DROP period	0	22
Number with 36-month max DROP period	6	8
Number with 48-month max DROP period	3	1
Number with 60-month max DROP period	9	4
Do member contributions continue during DROP?	7 yes (1 is voluntary)	36
Are member contributions added to DROP account?	6	36

City/State	**Alabama** www.rsa.state.al.us	**Anne Arundel County (Md.)**	**Arizona** *www.psprs.com*
Type of DROP	Forward	Forward	Forward
Groups covered	Teachers and general employees	Police and fire	Public safety personnel
Eligibility	25 Years of service and age 55	20 years of service	20 years of service
DROP period	Min of 3 years, max of 5 years	36 to 60 months	Max of 60 months
Interest credit rate	Same as active accounts (currently 4%)	8%	9.0% currently – Rate of return determined by fund manager
COLAs	No	Yes	No
Mandatory retirement	No	Yes	No, but penalized by loss of all interest credited to DROP account
Employee contributions	Yes	No	No
Treatment of EE contribs.	Deposited into the DROP account	N/A	N/A
Disability benefits	No, the employee would just be considered retired on the date of disability (LS of DROP account)	Yes	Yes
Death benefits	DROP account goes to beneficiary, any contributions, and depending on benefit election	DROP benefit	Yes, but based on amount calculated at beginning of DROP plus DROP account
Annuity and pay-out options	Lump sum	Lump sum only	Lump sum of account balance and monthly annuity of retirement benefit
Phase-in of coverage	No	Limit on new members per month	No
Sunset provisions/ future cost analysis	No	No	Yes. 06/30/2006
Effective date of DROP	06/01/2002	01/01/2001	07/01/2001
Notes	If termination occurs within the first three years of DROP, the retirement allowance payments will be forfeited and they will only receive employee contributions and interest. Additional benefits can be earned after DROP participation period.	Must be in DROP a minimum of 36 months	Must take money at the end of DROP (within 30 days)

City/State	**Austin**	**City of Baton Rouge**	**Dallas**	**Denver** *www.derp.org*
Type of DROP	Forward and back	Forward	Forward	Forward
Groups covered	Fire	Police, fire and general employees	Police and firefighters	General employees
Eligibility	45 years of age and 10 years of service or 20 years of Service	Actively contributing and eligible for service retirement	Age 50 and eligible for retirement	Normal retirement (age 65) or rule-of-75 (and age 55)
DROP period	Max of 7 years	Maximum of 60 months	No limit	Max of 48 months
Interest credit rate	5%	5-year average of investment returns	At actuarial rate – 8.75%	7.75% currently (plan's assumption for investment return)
COLAs	Yes	No	Yes	N/A
Mandatory retirement	Yes	No	N/A	No
Employee contributions	Yes	Not during DROP	No	N/A
Treatment of EE contribs.	Credited to the DROP account	Offset against pension amount over member's life expectancy	N/A	N/A
Disability benefits	No	Not after DROP entry	No	No
Death benefits	Yes	Yes	DROP Benefit	Yes, same as actives plus DROP account
Annuity and pay-out options	Lump sum of account balance (or periodic payment) and monthly annuity of retirement benefit	Mandatory minimum withdrawals if under age55 at retirement	Lump sum of account balance (or periodic payments)	Lump sum of account balance (or periodic payment) and monthly annuity of retirement benefit
Phase-in of coverage	No	No		No
Sunset provisions/future cost analysis	01/01/2002	None		Yes. 12/31/2004
Effective date of DROP	1995	01/01/1981	01/01/1993	01/01/2001
Notes		Member cannot earn additional service credits following DROP participation		Social Security make-up benefit added to DROP if born 1938 or later. Extra accruals if continue to work after 48 months.

City/State	**Florida** *www.frs.state.fl.us*	**Hollywood (FL)** *www.hollywoodpolicepensionfund.com*	**Houston** *www.hfrrf.org*
Type of DROP	Forward	Forward	Forward
Groups covered	Teachers and general employees	Police	Firefighters
Eligibility	Normal retirement (vested and age 62) or 30 years of service	Eligible to receive a service retirement and at least age 50 and 25 years of service (but less than 28)	Retirement eligible
DROP period	Max of 60 months	30 years less pre-DROP service (max of 60 months)	1 month to 10 years
Interest credit rate	6.50%	Investment return on assets in which such amounts are invested by the board	5-year average of pension fund
COLAs	Yes, 3%	Yes	Yes (if you are eligible)
Mandatory retirement	Yes	No	No
Employee contributions	No	Yes	Yes, 7.7% of pay
Treatment of EE contribs.	N/A	Employee contributions are credited to DROP account	Employee contributions are credited to DROP account each month plus interest
Disability benefits	No	No	Occupational disability – only general
Death benefits	Yes, DROP benefits and continuing monthly benefit	Yes	On-duty death
Annuity and pay-out options	Lump sum of account balance (or partial) and monthly annuity of retirement benefit	Lump sum of account balance (or periodic pay-ment) and monthly annuity of retirement benefit	Lump sum of account balance (or periodic payment) and monthly annuity of retirement benefit
Phase-in of coverage	No	No	No
Sunset provisions/future cost analysis	No	No	No
Effective date of DROP	07/01/1998	01/01/1991	09/01/1995
Notes		Voluntary after-tax contribution allowed	Can continue to work after 10 years with frozen account

City/State	**Louisiana** *www.trsl.state.la.us*	**Louisiana** *www.lasers.state.la.us*	**Louisiana** *www.lsprs.state.la.us*
Type of DROP	Forward	Forward	Forward
Groups covered	Teachers	General employees	Police
Eligibility	Earliest of: 30 years of service, 55 and 25 or 60 and 10 (depends on the plan) and member must be employed for entire DROP period (service does not include unused sick or annual leave)	Eligible for regular retirement only: 30 years of service, 25 years of service and age 55 or 10 years of service and age 60	Eligible for regular retirement only: 25 years of service or 20 years of service and age 50
DROP period	1 month to 36 months	Max of 36 months	Max of 36 months
Interest credit rate	None – only after DROP period ends	None – only after DROP period ends	None – only after DROP period ends
COLAs	No – only after termination	No	No
Mandatory retirement	No	No	No
Employee contributions	No	No	No
Treatment of EE contribs.	N/A	N/A	N/A
Disability benefits		No	No, the employee would just be considered retired on the date of disability
Death benefits	Yes	No	No, DROP account goes to beneficiary
Annuity and pay-out options	Lump sum of account balance (or periodic payment – total, annual or monthly)	Lump sum of account balance (or periodic payment)	Lump sum of account balance (or periodic payment)
Phase-in of coverage	No	No	No
Sunset provisions/future cost analysis	No	No	No
Effective date of DROP	01/01/1992	07/01/1992	07/01/1992
Notes	Has alternative partial lump sum option called ILSB	Window of eligibility is only 3 years and 60 days from earliest eligible date DROP period is reduced by waiting time after eligibility begins – once you enter DROP you are considered a retiree	Once you enter DROP you are considered a retiree

City/State	**Maryland**	**Memphis** *www.memphisfirefighters.org*	**Miami**
Type of DROP	Forward	Forward	Forward self-directed
Groups Covered	Police	Fire fighters	General employees
Eligibility	At least 22 years of credited service but less than 28	NRA and 25 years of service	Age 55 with 10 years or age + service at least 70
DROP Period	Max of 48 months	Max of 36 months	Max of 36 months
Interest Credit Rate	6.00%	25% of 90-day Treasury Bill yield paid quarterly	Investment options – employee chooses
COLAs	Yes		Yes
Mandatory Retirement	Yes	Yes	Yes
Employee Contributions	No	No	No
Treatment of EE Contribs.	N/A	N/A	N/A
Disability Benefits	Yes, DROP is then revoked.	Yes, DROP is then revoked	No
Death Benefits	Yes	Yes, DROP is then revoked	No special line-of-duty benefit
Annuity and Pay-out Options	Lump sum only	Lump sum of account balance	Lump sum, annuity, periodic payments, rollover
Phase-in of Coverage	No	No	None
Sunset Provisions/Future Cost Analysis	No		None
Effective Date of DROP	2000		2002
Notes		Quarterly entry dates	Also offers a back DROP with maximum 36 months, interest based on "assumed investment return" but benefit to be actuarially equivalent to benefit earned at date of retirement. They also have a police and fire plan.

City/State	Milwaukee County	Missouri	Ohio *www.op-f.org*
Type of DROP	Back (retroactive)	Forward	Forward – Not available until 2003
Groups Covered	General employees	Police	Police and fire fighters
Eligibility	Election can be made back to the earliest date eligible to retire.	20 years of service or age55	25 years of service and age 48
DROP Period	No limit	Max of 60 months	Min of 3 years, max of 8 years
Interest Credit Rate	Based on annual rate of return 8.5% 2001; 9.0% 2002	Based on annual rate of return	5.00%
COLAs	Yes, 2%	No	Yes
Mandatory Retirement	N/A	No	No, but DROP benefits will be forfeited
Employee Contributions	N/A	Yes, voluntary, 7% of pay	Yes, 10% of pay
Treatment of EE Contribs.	N/A	Employee contributions are credited to DROP account	Employee contributions credited to DROP: Year 1: 50%, Year 2: 50%, Year 3: 75%, Year 4: 100%
Disability Benefits	N/A	Yes, but DROP is forfeited	Yes, DROP is either revoked and disability retirement accepted or stay in DROP and decline disability retirement
Death Benefits	N/A	Yes	Yes
Annuity and Pay-out Options	Lump sum of account balance and monthly annuity of retirement benefit	Lump sum of account balance or monthly installments over 10 years and monthly annuity of retirement benefit	Lump sum of account balance (or periodic payments)
Phase-in of Coverage	No	No	No
Sunset Provisions/Future Cost Analysis	No		The board will review the DROP program each quintennial
Effective Date of DROP	2001	08/28/1997	01/01/2003
Notes	Under investigation		Employer makes no additional contributions for DROP employees – net zero cost – member receives 50% J&S coverage at no charge

City/State	**Oklahoma**	**Philadelphia** *www.fop5.org*	**San Antonio**
Type of DROP	Forward	Forward	Back
Groups Covered	Firefighters	Police and fire	Police and fire
Eligibility	20 years of service	NRA and 10 years of service	20 years of service
DROP Period	60 months	48 Months	Maximum of 36 months
Interest Credit Rate	Maximum of actuarial assumption and 2% below actual return	Yes	N/A
COLAs	Yes	No	No
Mandatory Retirement	Yes	Yes	No
Employee Contributions	No	No	N/A
Treatment of EE Contribs.	N/A	N/A	N/A
Disability Benefits		Yes	N/A
Death Benefits	DROP benefit	Yes, death benefit and DROP account	N/A
Annuity and Pay-out Options	Lump sum only	Lump sum of account balance and monthly annuity of retirement benefit	Lump sum and monthly annuity of retirement benefit
Phase-in of Coverage		No	No
Sunset Provisions/Future Cost Analysis		Test period is 4 years	01/01/1999
Effective Date of DROP		06/28/1999	10/01/1995
Notes			

Appendix C: Milwaukee Journal Sentinel Article

Lucrative pension plans spreading across country

None as generous as Milwaukee County's, but some can come close

By JESSICA MCBRIDE and AVRUM D. LANK

Journal Sentinel ***July 7, 2002***

Pension plans that can provide government workers six-figure golden handshakes, including million-dollar payouts in some cases, are spreading across the country, creating the conditions for a taxpayer-subsidized fiscal firestorm. While none appears quite as generous as Milwaukee County's infamous pension plan, a few come close.

Just as in Milwaukee County, the plans typically are adopted with little public discussion or debate. Increasingly, they cover elected officials.

No central clearinghouse is keeping track, but the schemes - all variations of "Deferred Retirement Option Plans" or DROPs - are now offered to tens of thousands of public workers. Texas alone had 38 DROP plans in 2000.

Although they vary in the details, all DROP plans allow workers to accrue monthly pension payments in escrow accounts before they actually retire. When the workers finally do retire, they receive all the accrued money in lump sums, often after high guaranteed interest returns and cost-of-living increases. They also continue to receive their monthly pension benefits for life, although they are pegged to the rate earned when the workers first entered the DROP plan.

Often, high-salaried veteran workers can retire with lump sum payoffs of hundreds of thousands, or even more than $1 million, in addition to their monthly pensions. As was the case in Milwaukee, the Internal Revenue Service limits put a ceiling on potential payouts in some cases. But at least one city - Dallas - has set up a plan to get around the IRS ceilings by paying supplemental benefits directly from general city coffers.

Among the plans:

- The Dallas DROP has covered police and firefighters since 1993. "Someone could get a $1 million check," according to Don Rohan, assistant administrator for the Dallas Police and Fire Pension Fund.

- In Houston, all city workers, including elected officials, are eligible for a back DROP pension with no limit on the number of years the lump sum account can accumulate. A similar scheme in Milwaukee allowed lump sum payments of more than $1 million for senior county staff. When taxpayers learned of it, their outrage led to the resignation of

County Executive F. Thomas Ament, the ouster of his top aides and, so far, the recall of five supervisors.

- Schoolteachers and administrators in Arkansas are eligible for a lucrative DROP. Although the largest lump sum earned so far has been $235,000, "someone could get a million," according to Deana Dixon, manager of membership and payroll for Arkansas Teachers Retirement System. "It would be the extreme, not the norm."

- The Florida pension system has implemented a maximum five-year DROP program that applies to all 813 employers participating in its system, including elected officials. It applies to the university system, where some veteran workers earn annual salaries of more than $500,000 and could accumulate huge lump sum payoffs.

- The City of San Diego also has a five-year plan - the most common variation nationally - that officials say could easily produce lump sums of $500,000.

Incentive to stay?

Proponents argue that DROP plans are creative ways to allow public workers to build capital and entice them to stay longer. That was the rationale given by officials in Milwaukee County.

The plans are becoming more popular as government agencies fear the mass retirement of baby boomers.

Occasionally, as is the case in Milwaukee, Houston and other communities, there is a "back DROP" provision. Under such a plan, employees can wait until they retire to select a date for the DROP payments to start accruing - in effect creating a lump sum account, including accumulated interest, after the fact.

Federal tax law allows the lump sums to be transferred to an Individual Retirement Account with no taxes due. Only when money is taken out of the IRA must taxes be paid. In addition, the IRA is the pensioner's property, meaning it can be passed on to heirs.
Former Milwaukee County Human Resources Director Gary Dobbert - who said he picked up the DROP concept at a national conference - created a particularly lucrative version by lumping together generous elements, including a back DROP and a high guaranteed interest rate. In addition, Milwaukee County boosted underlying pension benefits by up to 25% for long-term employees.

DROPs can be crafted to be "cost neutral," with low enough monthly pensions to balance the lump sums paid out of pension funds. However, such plans don't appear to be common.

Some communities have turned "what had been a Yugo into a Cadillac," said Ira Summer, a California actuary who has spoken on the topic at national conferences and designed DROP plans.

"The first few DROPs were real careful, and were designed to be cost neutral," Summer said. "Word started spreading around that you've got these DROP plans, they're free. So people started making improvements, started adding higher interest rates, longer periods of time, letting anybody into the plan, and by adding on the bells and whistles, plans that had initially been cost neutral and free to employers started to become less free. Milwaukee was the first one to blow up, but there are a bunch down in smaller cities in Florida that are ridiculously generous."

Opposed in California, NYC

Although DROP plans are commonly sold as cost neutral, government fiscal studies around the country have found dramatically different results. For that reason, in part, California Gov. Gray Davis, a Democrat, and former New York Mayor Rudy Giuliani, a Republican, successfully opposed DROP plans.

Some fiscal studies have found that even scaled-back DROPs would cost millions of dollars, while others have said they are essentially free and still others have said there is no way to tell.

In Arizona - where the state system has a five-year DROP that also applies to elected officials - a fiscal study note projects that it will cost more than $4 million in 2004 alone. In Tennessee, a proposed plan to allow teachers and administrators to enter a DROP was projected to cost $54 million.

The fiscal note for a recently adopted DROP for Ohio police and firefighters said the plan "could increase or decrease costs."

As Milwaukee County's experience shows, retirement trends can be difficult to predict. In January, some county workers rushed to retire, fearing that the plan would be rolled back. The rush to retire and a soft stock market could cost the county millions of dollars more than expected.

And figuring out the cost of DROPs hinges on unknowns such as the overall investment results of a pension fund. Some DROPs are riskier for a fund because they mandate that DROP accounts never decrease, even if the overall pension fund has a negative investment return.

Proponents argue that DROP plans give communities the ability to plan for future retirements. Some communities have faced a mass exodus of veterans - essentially their brain trust. Others have even allowed DROP participants to retire, draw their lump sums, and reassume their jobs.

The City of Baton Rouge, La., created the first DROP in 1981. The elected coroner has accrued the largest account to date, around $500,000, even though the DROP now is limited to five years.

"We were surprised how it spread like wildfire. We should have patented the thing," said Jeff Yates, retirement administrator for the City of Baton Rouge and Parish of East Baton Rouge Employees' Retirement System.

He noted that DROPs first were picked up by Southern law enforcement agencies but increasingly have spread around the country to include other public workers and sometimes even entire state systems.

Yates believes unlimited plans developed partly because pension systems had "so much money they didn't know what to do with it" during the boom economic period of the 1990s. Many of the programs assumed a continued high rate of return on pension fund investments and have been forced to make large adjustments for the falling stock market of the past two years.

And while local governments, such as Milwaukee County, have argued that DROPs are necessary to retain veteran workers, they were actually designed for the opposite purpose. Baton Rouge created the DROP to save money by nudging higher paid veteran workers out the door, Yates said. Further, the Baton Rouge program was open only to employees who were not yet eligible for their maximum pension benefits.

"I'm afraid all DROPs will be lumped together in a negative connotation, but my underlying premise is that if a system can fund benefits it's OK to give them," Yates said. "It's when you get in a position where you've granted benefits you can't take away and funding begins to deteriorate that you find yourself in trouble."

Yates said the Louisiana attorney general is reviewing whether DROP accounts can lose money if a pension system has a negative return.

Pension plan reviews

Pension system officials were reluctant to provide specific information about individual DROP accounts. But reviews of local ordinances, pension plans and annual reports showed that:

- In Dallas, where a DROP pension option is offered to police officers and firefighters, 808 people were enrolled in DROP as of January 2001. Four 63-year-olds had an average account balance of $420,226 at that time. As in Milwaukee, there is no limit on how many years past an eligible retirement date someone can keep working and building up a lump sum account in the Dallas DROP. The Dallas plan offers a generous interest rate, currently 9% on the lump sums, while also increasing the base pension 4% annually. Dallas officials defend their DROP program, saying they were facing a retention crisis and DROP has pushed the average retirement age back. Pension system chairman Jerry Brown said an actuarial study determined that Dallas' plan was saving money by delaying retirements.

- In Houston, all city workers and police officers may enter DROPs, which have no limit, according to the state's Pension Review Board. Interest is equal to the average annual return earned by the fund in the previous five years. The Houston municipal pension system's annual report says that in 2000, 277 workers were in the DROP program. A person can receive 90% of his or her salary as pension in Houston, and there is a 4% annual cost of living adjustment. Asked for the highest lump sum paid to date, Houston General Counsel Erin Perales wrote that the pension system "has no documents responsive" to that question. Asked whether the program was considered "cost neutral," she wrote that under Texas law a governmental body does not have to answer such questions.

- In Arkansas, teachers and school administrators have been allowed since 1995 to enter a DROP program with a 10-year limit. The top lump sum payout to date is $235,000 for an employee who made $66,000 a year. Payroll manager Dixon acknowledges that the program could generate a lump sum of over $1 million, in addition to a monthly pension, for a senior employee making more than $100,000 a year. She said the Arkansas plan, which has about 5,000 participants and a 6% fixed interest rate, was implemented because "we were having a hard time keeping teachers." While actuarial studies said the program would be cost neutral, Dixon said "the public might have a problem" if someone gets a million-dollar payday.

- In Ohio, police and fire officials were granted an eight-year DROP plan option in April by the state's General Assembly - a plan that could produce a million-dollar payout. No cost of the program was estimated in a fiscal note, but it did say "local governments may pay higher salary costs overall for police and fire departments if higher-salaried, longer-tenured employees decide to continue employment due to the incentives created by the deferred retirement option plan."

- The City of San Diego's DROP has a five-year limit but can still generate huge lump sums because of the city's generous base benefits. Some workers who stay long enough can actually receive more than 100% of their last annual salary in pension benefits, Summer said. That adds to what can be tucked away in lump-sum accounts for the last five working years. "In San Diego, you can't quite get up to a million, but you can get big numbers," he said. The plan includes elected officials.