OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM
277 EAST TOWN STREET, COLUMBUS, OH 43215-4642
1-800-222-PERS (7377)
www.opers.org

MEMORANDUM

DATE: April 6, 2005

TO: OPERS Retirement Board Members

FROM: Karen Carraher, Director – Finance
Mark Snodgrass, Assistant Director – Accounting & Budgeting

RE: **IV. Discussion Items:**
B. Deferred Retirement Option Plans

Purpose – To provide the Board with background information and explanation of how Deferred Retirement Option Plans (DROP) function and the advantages and disadvantages of Deferred Retirement Option Plans. This educational information is in response to a question from a Board member.

Background – In July 2001, prior to the Partial Lump Sum Option Plan (PLOP) legislation, staff presented the Board information on DROPS and PLOPS and the advantages and disadvantages of each type of plan. At that time, staff was seeking guidance from the Board as to whether the staff should pursue either a DROP or PLOP or not pursue any deferred retirement option. Following that discussion in September 2001, the Board authorized staff to proceed with joining other Ohio Retirement Systems in seeking legislation to implement a PLOP. At that time, the Board felt that the PLOP provided the most actuarially cost neutral option for deferred retirement. During 2002, Senate Bill 247 authorized OPERS to establish a PLOP for its members no later than July 1, 2004.

In January during the OPERS legislative report, a question was raised about other systems' DROPS and if they have been effective in encouraging members to work longer. At that time, OPERS staff indicated that we would bring back information to the Board regarding these plans. OPERS staff had already planned to provide two educational sessions for the Board designed to provide new Board members with a foundation to actuarial concepts. Thus, the DROP education seemed appropriate to follow those actuarial educational sessions.

Issues -- The goal of the DROP presentation is to educate the Board on how DROP plans work, the types of DROP plans, the advantages and disadvantages associated with DROP plans and the actuarial considerations with DROP plans.

Next Steps -- Based on the educational session, staff would like feedback from the Board on whether to pursue any further delayed retirement options.
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OPERS

Ohio Public Employees Retirement System

Deferred Retirement Option Plans

→ DROP’s ←

Forward DROP’s and Back DROP’s

April 20, 2005

Gabriel, Roeder, Smith and Company

What is a DROP?

Deferred Retirement Option Plan

- A Forward DROP is a plan where the member continues to work and the accrued pension benefit is "paid" into a special account that is maintained until the member actually retires.
- A Back DROP is a plan where, at time of retirement, members may choose to have their benefits refigured as though they had entered a forward DROP in the past.
- In either case, the pension becomes frozen at time of entry into DROP.

What is a DROP?

- Both types of DROPs encourage members to work longer.
- A Forward DROP usually places members at risk for bad decisions. For example, in most forward DROPs, members who have large pay increases following DROP entry, cannot "un DROP" and have the final average salary increased.
- In a Back DROP members have all facts available at time of retirement and simply choose the best plan.

What is a DROP?

- Back DROPs are inherently more costly, because the Back DROP Plan Sponsor assumes the risk. Decisions are always in the member’s favor.

The PLOP Alternative

- PLOP stands for “Partial Lump Sum Option”
- Members can take part of the monthly benefit in a lump sum.
- Future benefits are reduced to account for the lump sum already received.
- Like a traditional DROP, a PLOP provides a lump sum at retirement.
- Unlike a DROP, it is easy to design a cost neutral PLOP.

The OPERS PLOP

- Senate Bill 247 created the OPERS PLOP effective 1/1/2004.
- If the retiring member elects to PLOP, he or she must select a lump sum that is between 6 and 36 months worth of benefit.
- Future benefits are actuarially reduced.
- The PLOP provides a valuable choice to the retiree, without adding cost to OPERS.

DROPs and Cost Neutrality

A common design mission of DROPs is to make them cost neutral. Ways for a DROP plan to be cost neutral:

1. Design the plan so that everyone gets exactly the same actuarial value regardless of DROP election. A partial lump sum option (PLOP) does that nicely.
2. Design the plan so that there are winners and losers. The losers pay for the benefits received by the winners. This is unpopular with the losers.
3. Design a plan that produces a heavy incentive to remain working longer. Incentives to work longer tend to be unpopular.

DROP Perspectives

Following Election of DROP:

- Retirement system's perspective: Person electing the DROP appears to be retired.
- Employer's perspective: Person electing the DROP may appear to be an active employee for some purposes and a retired employee for others.

DROP Operation

- Upon satisfaction of eligibility conditions:
  - Pension is frozen on the date of DROP participation.
  - DROP account is created and credited with a % of the frozen monthly pension during the remaining period of employment. The % is often less than 100%.
  - May also be credited with employer and/or employee contributions and/or interest credits during DROP period.
  - At actual retirement member receives monthly pension plus DROP account (lump sum or annuity).

Conditions Leading to DROP

- Plan includes maximum benefit (100% of pay). Can act as a benefit enhancement.
- Want to induce people to work longer
- More choices are better
- Everyone else has one

DROP Variations

- DROP account is credited with payments for up to a maximum number of (e.g., 5) years.
- Sometimes a minimum number of years in DROP is required, but what happens if a person DROPs and then does not stay the minimum?
- Some provide a maximum DROP participation period. What happens if a person overstays the maximum?
- DROP account is frozen after a cut off date.
- DROP interest credited at a fixed rate (e.g., 7%).
- Variable rates or self-directed accounts may be feasible.

Alternatives Upon Actual Retirement

- Lump sum distribution of DROP account balance, and pay the appropriate taxes.
- Roll over account balance to an eligible plan or IRA.
- Convert account balance to a monthly benefit to enhance the regular pension.
- Leave the account balance in the retirement system and draw down a portion in periodic payments.

Potential Benefits to Members

- DROP is a means of providing for a lump sum distribution of a portion of a member’s interest in a retirement plan.
- DROP participation may enhance the member’s overall benefit value, particularly if salaries near retirement are not increasing, or there is a cap on accruals.
- People can continue working in a job they like without forfeiting retirement benefits. In other words, they can effectively draw both pension benefits and working pay at the same time.

Possible Disadvantages for Members

- Eligibility conditions often are such that only a small subset of members actually benefit from the plan.
- Younger members may see impaired promotional opportunities.
- Plan benefit increases during the DROP period are generally not passed on to DROP participants.
- Pay increases during the DROP period are not reflected in the actual benefit at retirement.
- By foregoing future benefit accruals, future cost-of-living adjustments on the missing accruals are also lost.
- DROP participation can lead to lesser total benefit values, even in some generous plans.

Possible Disadvantages for Members

- If the DROP percentage is less than 100%, members may feel penalized for participating.
- By electing the DROP lump sum, the member’s future pension payments will replace less of pre-retirement income.
- Lump sum might be used for non-retirement purposes.
- Might be forced to work beyond planned retirement date in order to get DROP.

Potential Benefits to Plan Sponsors

- Means of offering additional benefit choices at little cost (maybe).
- Valuable long-service employees may be induced to delay retirement.
- Employer can plan for the replacement of long service employees.

Disadvantages for Plan Sponsors

- Plan administration is more complex and costly.
- It is difficult to design a truly cost-neutral plan that is popular.
- Payroll costs could rise if people extend their working careers.
- Very large lump sums can accrue in DROP plans leading to unfavorable publicity.

Cost Neutral ?

- Actuaries often get asked to design a DROP that is cost neutral.
- What does “Cost Neutral” mean to an actuary?

Cost Neutral

- Current contribution rates remain unchanged.
- Projected patterns of future contributions rates remain unchanged.
- There could be other definitions.
- Usually plans have a provision to review the cost neutrality or lack thereof after a period of years.
- Such reviews are difficult and subjective. Difficult to determine what would have happened if there had been no DROP.

Actuarially Cost Neutral

- If people retire earlier than would otherwise be the case, the plan cannot pay 100% of the benefit into the DROP account and still be cost neutral.
- If people retire earlier, replacements will be hired sooner and retire sooner. Thus, more people will draw benefits.

Therefore, each person’s benefit must be reduced to keep the Plan cost neutral. The reduction could be severe.

Members will tend to not like this plan.

Actuarially Cost Neutral

This implies a long service requirement for participation, so that people cannot draw benefits much sooner than they would have anyway, and possibly a minimum participation period to ensure that people will retire later.

Corollary

- If later retirement is not an objective, a partial lump sum option (PLOP) is an alternative to a DROP. (Currently available to members of OPERS.)
- Why?
  - – It is easy to understand and to administer.
  - – It has fewer traps.
  - – Benefits are preserved but have been restructured into a more desirable form.

Gray Cases

- It is not always possible to predict how the DROP affects human behavior. This is why many plans that are supposed to be cost neutral pay less than 100% into the DROP account.

DROP Conclusions

- If a DROP causes people to retire later than would otherwise be the case, the DROP can pay people more in total than they would have received without it and it can still be cost neutral.
- If a DROP causes people to retire earlier than would otherwise be the case, it must pay each person less in total than if there had been no DROP in order to be cost neutral.

DROP Conclusions

- If a DROP has no effect on the timing of retirements, the DROP must create winners and losers or be arranged so that each member receives the same total benefit each would have received if there had been no DROP, if the plan is to be cost neutral.
  - The only difference will be the lump sum option.
  - Can be accomplished with a partial lump sum option (PLOP) without a DROP.

Major Design Issues

Determining the relationship between retirement eligibility vs. DROP eligibility

- How long can members stay in a DROP?
- How long must members stay in a DROP?
- What percent of accrued benefit goes into DROP?

Other Design Issues

- Death or disability during DROP
- Benefit increases during DROP
- Accrued sick/vacation leave
- Interest credits on DROP account
- Distribution options
- Un-dropping, Backdropping

Important Design Principle

- In order for a DROP Plan to be “cost neutral” in the actuarial sense, and pay higher benefits to people who elect it, there must be at least one major design issue that at least some people don’t like.

DROP Valuations

- In order to evaluate the effect of a DROP, the actuary must make an assumption about the extent to which the DROP will cause people to alter their planned retirement date.
  - This is a very important assumption that materially affects the end result.
  - It is important that the Board and the Actuary agree on this assumption in advance.

Sample DROP Plans

#1 - State Plan

- Forward DROP
- 28 years of service required for eligibility
- DROP period - maximum 5 years
- 7.75% interest credit. This caused a lot of controversy during years when the investment portfolio was losing money,
- 75% of accrued pension credited to DROP account
- Lump sum only

Sample DROP Plans

#2 - State Plan

- Forward DROP
- Age 62 or 30 years of service required for eligibility
- DROP period - maximum 5 years
- 6.50% interest credit
- 100% of accrued pension credited to DROP account
- Lump sum or annuity options

Sample DROP Plans

#3 - State Police/Fire Plan

- Forward DROP
- Age 48 and 25 years of service required for eligibility
- DROP period - minimum 3 years, maximum 8 years
- 5.0% interest credit
- 100% of accrued pension credited to DROP account
- Increasing portion of Member contribution credited to DROP accounts.
- Lump sum or periodic payments

Sample DROP Plans

#4 - State General Employees Plan

- Back DROP
- Must be 2 years past normal retirement eligibility
- DROP period - minimum 2 years, maximum 5 years
- 0.0% interest credit
- 90% of accrued pension credited to DROP account
- Lump sum or periodic payments

Sample DROP Plans

#5 - City Plan

- Forward DROP
- Age 55 with 10 years of service or 70 points required for eligibility
- DROP period - maximum 3 years
- Interest based on member investment choices (self-directed)
- 100% of accrued pension credited to DROP account
- Lump sum or annuity options