1. Background

1.1 What is a DROP?

DROP stands for Deferred Retirement Option Program[1]. It is a defined benefit (DB) plan design feature that is growing in popularity while causing some controversy. The majority of DROPs are currently found in public sector plans, especially those covering police and fire employees. However, there is growing interest among other plans both in the public and private sector.

A DROP is an option provided to active participants of some retirement plans. It allows members who elect DROP the option to continue to work beyond their normal retirement date (NRD) and convert the value of part of the retirement benefit into a lump sum. The lump sum is typically defined as the accumulation of the annuity benefit the participant would have been entitled to receive at the NRD. To get the DROP lump sum, a member must give up future annuity accrual[2], often of approximately equal value to the lump sum.

As an example, many police officers or firefighters reach their NRDs by age 50 with a benefit of at least 50% of salary. Assume a final average salary of $40,000. In a traditional plan the employee could choose to retire with a benefit of $20,000/year or could continue to work and earn a higher annuity. Under a DROP plan, the $20,000 annuity is frozen but the employee begins to accumulate a lump sum. The lump sum is based on credits of the deferred $20,000/year annuity plus (in most cases) interest plus (in some cases) employee contributions. After three years, the lump sum may accumulate to $75,000. Many DROP lump

---

[1] Sometimes the word "deferred" is replaced with the word "delayed" and/or the word "program" is replaced with the word "plan".

[2] It would be accurate to say the participant is giving up annuity accruals to get lump sum accruals. Accruals may not end when a participant elects DROP but rather continue at a different rate and in a different form.

sums are in the $200,000+ range. Payments are made when an employee stops working.

Is a DROP participant active or retired? From the retirement plan's perspective, there are two different ways to view an employee who has elected DROP participation. One is that the employee is still active. This view may mean employer and employee contributions continue, as does eligibility for death and disability benefits. The other perspective is to view this employee as retired, and discontinue contributions and disability eligibility. A DROP can also be designed in a way that combines elements from the two perspectives; for example, a DROP participant could be eligible for death but not disability benefits. Designing or negotiating a DROP where parties have different answers to this question often creates conflicts. This is discussed later in this report.

It is the authors' view that a plan with a DROP feature retains its identity as a DB plan, even on that portion of the plan that contains the DROP lump sum. This is basically the same issue as with cash balance plans; they look like defined contribution (DC) plans but are truly DB plans because the benefits are definitely determinable and they lack certain attributes of DC plans (any plan that is not a DC plan is by definition a DB plan). One possible exception might be **self-directed DROPs** (see Section 2.3). At this point in time there are arguments over how a self-directed DROP should be viewed that this study will not resolve. Similar arguments exist with self-directed cash balance plans. See Sections 5.1 and 5.4.

1.2 Purpose of this Study

The main purpose of this study is to provide actuaries with enough information to gain a detailed understanding of the issues involved in DROP plan design and funding.

Issues with DROP designs and cost are significant. For example, a February 2002 newspaper article on a back DROP design had the following headlines:

> ***Benefits in … pension plan cause scandal***
> ***Some officials would get million-dollar payouts***

Our goals are:

- To provide a background study that actuaries can use when discussing proposed DROP plans with their clients. This includes a survey of design information (as of 2002) and a discussion of issues. Please note, this report addresses current design information. Since DROPs are an evolving plan design, new design elements appear constantly.
- To provide the actuary with the key considerations involved in estimating the cost of a DROP proposal.

Some issues will appear several times in this report as we examine them from the separate perspectives of an actuary, a plan sponsor and a DROP participant.

This study will also cover several common tax issues. This document should not be taken as legal advice. Plan sponsors should seek and retain legal counsel when considering a DROP feature.

Notes:

1) This report contains a glossary of terms. The first time a defined term is used it appears in bold.

2) We will often refer to individuals as plan participants even though in the public sector they are often referred to as members.