SOCIETY OF ACTUARIES

3. History, Experience and Case Studies of DROPs

The first DROP design began in East Baton Rouge Parish in 1981 and covered all groups of employees (police, fire and general employees). The initial plan was intended to be cost neutral. The neutrality was partly as a result of requiring the DROP to be elected prior to a scheduled post-NRD longevity pay increase. After about three years a DROP feature was added to the Louisiana Municipal State Police plan and then to the state firefighters' plan. There were a few other DROPs started in the 1980s. DROPs began to spread in a material fashion starting in the mid-1990s. Some of the earlier plans included: Louisiana, Oklahoma, Dallas and Hollywood, Fla. Many of the early DROP plans were limited to public safety employees.

Below are some specific DROP experiences in certain jurisdictions.

3.1 Dallas Police and Fire Pension System

The Dallas plan began in 1993. It is one of the few forward DROPs that has an unlimited DROP participation period. One-hundred percent of the frozen annuity is added to the DROP account. Participants are not eligible for disability benefits during the DROP participation period. The following experiences have been reported:

- Employees have worked longer after NRA since the DROP was added.
- The plan's actuary has reported that the DROP is basically cost neutral.
- The DROP participation rate is almost 100%.
- In a 2001 survey, young members expressed concern about senior employees staying on longer.

The initial DROP was approved for only a five-year period. After the end of the five years (September 1997), a study was undertaken to measure the fiscal impact of the DROP. If the impact was negative, the DROP would be eliminated or modified. The initial 1992 cost estimate assumed that DROP would add an annual cost of 0.24% of payroll and that employees would work an average of 1.6 years longer. The results of the five-year study showed that retirement ages have increased from 52.4 before the DROP to 57.7 after the introduction of DROP.

The 1997 study stated that most members elected DROP and most did so within two months of becoming eligible. The study contains retirement rates and information on when DROP was elected after first eligibility.

Given the unlimited election period and the plan design, a high and immediate participation rate should not be surprising. Care should be taken not to assume this experience would emerge for plans with materially different provisions.

3.2 Anne Arundel County (Md.)

Anne Arundel County added a DROP feature in CY2001 for firefighters and CY2002 for police officers. The DROP required a minimum participation period of 36 months and a maximum of 60 months. Employees electing DROP must retire after 60 months. Employees that leave before being in the DROP for 36 months get the non-DROP benefit. The initial experiences of these plans have been as follows:

- In the first 16 months of the DROP existence, 40 out of 79 eligible firefighters elected to join DROP. The percentage electing to join in the future is expected to increase slightly. Current estimates are that 60%-70% will elect DROP. Officers tend to elect DROP more often than non-officers.

- After three months, only 10 out of 129 eligible police employees have elected to join DROP. It appears that police officers have materially less interest in DROP than firefighters. The current estimate is that only about 20% will elect DROP. Police tend to work less after retirement eligibility and many do not expect to stay the 36 months required to receive the DROP balance as a lump sum. Many of the senior officers who were expected to favor DROP have been electing to retire and take senior “security” positions related to terrorist concerns (e.g., head of security for a local utility company).

3.3 Pennsylvania Plans

Lancaster, Pa.

The firefighters of Lancaster proposed a DROP plan in their contract negotiations with the city. The proposed DROP was designed to be cost neutral. The union and the city were unable to reach agreement through negotiations, and the issue went to arbitration. Actuarial testimony was presented by both the union and the city. After considering testimony and arguments put forth by both sides, the arbitrator concluded that the DROP was a reasonable benefit for the firefighters and should be offered by the City.

State Aid

In Pennsylvania, cities are generally provided per capita state aid for certain employees covered under retirement plans. In the case of Lancaster, the state aid was $5,400 for each active firefighter. Even though DROP was simply an election under the retirement plan and in no other way impacted the individual’s employment, it was not clear at the time of the arbitrator’s award that state aid would be continued for the firefighters who had elected DROP. The arbitrator directed the city and the union to jointly seek the opinion of the Auditor General of Pennsylvania or a final resolution from the Pennsylvania judicial system on the issue of whether state aid could be denied to Lancaster on behalf of the firefighters who were active employees and participants in the DROP program. At the time of this study, the determination of state aid has not been finalized. The arbitrator’s ruling stated:

> *If it is determined with finality, that General Municipal Pension Fund State Aid may be denied to the City of Lancaster for Fire Fighters who are active employees participating in the DROP plan, the following shall occur:*
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> *The pension that would otherwise have been payable at the time of their DROP election, had they chosen to retire then, that is credited to each participant’s DROP account, shall be reduced by two-percent (.02) per one thousand dollars ($1,000.00); to a maximum of ten-percent in any year, that the City loses in General Municipal Pension Fund State Aid for each DROP participant.*

This proviso shall not be applied retroactively to DROP participants who have received the (DROP) lump sum.

There is a real possibility that state aid will not be paid for DROP participants and that the arbitrator would choose to reduce the pension increase if that were to occur.

3.4 Baltimore City

The Baltimore City Retirement System provides for a "20 & out[1]" retirement at 50% of final average earnings. Benefit credits continue after 20 years of service at a rate of two percent per year. In the early 1990s, Baltimore City was faced with the exodus of qualified police officers as soon as they met the 20 years of service requirement. The pension system also covered firefighters. Firefighters tended to continue employment well past the time of initial retirement eligibility. The system provided a post-retirement COLA using a formula based on investment earnings in excess of the actuarial assumptions.

The mayor requested ideas from the Fraternal Order of Police on ways to slow down the exodus of police officers. This led to the development of the Baltimore DROP.

The initial DROP credited the DROP account with the participant's frozen pension plus employee contributions plus interest at the pre-retirement investment return assumption of 8.25%. The accumulation period was for three years; however, retirement was not mandatory at the end of the three-year term. In order to continue the encouragement for officers to stay on, the DROP account was continued with further crediting of interest. Additional pension credits were also earned for service after the 3 year DROP period; however, no more pension amounts or employee contributions were added to the DROP account. After five post-DROP years (e.g., after 28 years of service = 20+3+5), the pre-DROP "frozen" benefit was recalculated on the new final average earnings. This was an expensive program, but it directly met the goals of continued employment. Retirements from the system had been averaging approximately 200 per year, but, during the first three years of DROP, there were less than a dozen service retirements. Retirements picked up at the end of the three-year period. Because of the significant attraction of the recalculation of the benefit, many officers continued employment past the end of the three-year period. In the late 1990s,

[1] "20 and out" refers to normal retirement after 20 years of service regardless of age.

the eight-year time period (3+5) for the recomputation of the pension benefit was reduced to four and a half years (3+1½).

DROP Cost Test

As in many jurisdictions, pension benefits in Baltimore City are subject to a contractual guarantee. Under the guarantee, the projected (not simply accrued) benefits cannot be diminished after they are granted. An exception to the contract right was put into place for the DROP benefit. The approach taken was to put a cost test in the initial DROP legislation. Under the cost test, essentially, if, after eight years of operation, the cost of DROP was not offset by net actuarial gains, the benefit would no longer be protected by the contract guarantee. The DROP benefit would still continue and it would take affirmative action by the City Council through an ordinance to reduce the DROP benefit. Moreover, the reduction of the DROP benefit could only be to the extent necessary to satisfy the DROP cost test.

While the concept is not particularly complicated, there are real complexities in practice. For example, when the plan was improved to reduce the recalculation period from eight to four and a half years, the benefit improvement was funded through actuarial gains. The DROP test language was not, and under the contract provisions could not be, amended to add a charge for the benefit improvement. The law calls for the system's actuary, in consultation with an actuary selected by the union, to make the determination of whether the cost test has been satisfied. At the time of this study, the actuaries have not agreed on the interpretations and determinations for the DROP cost test.

3.5 San Jose

In 1999 San Jose police and fire officers were negotiating for a DROP feature. Normally the benefit at retirement was 50% of final average pay plus additional accruals after 25 years of service. The city's charter required that the minimum benefit be at least 50% of final average pay. (It was noted that some alternate annuity forms could take the benefit below 50% after J&S form conversion factors were applied.) The DROP feature would freeze final average pay for benefit purposes but not for "charter" purposes. The city was not sure whether the DROP lump-sum value could be applied to pass the 50% charter requirement. A solution was to allow employees to elect a 50% current final average pay benefit without a DROP lump sum. This was never expected to be elected since the value would almost certainly be less than that of the DROP benefit. San Jose does not currently have a DROP.

3.6 New York City

New York City has not yet adopted DROP. However, we have discussed DROP with various fire and police officials and have some observations.

Firefighters were very much in favor of adding a DROP. Most firefighters already work many years beyond their NRA.

Police officers were materially less interested in DROPs. Few work any material amount of time beyond their NRA. The plan contains a “bad-boy clause” which adversely affects several participants each year. This means that certain events (e.g. failing a drug test) result in the loss of 100% of a participant’s pension. Police officers in the city generally do not view the value of a DROP as balancing the risk of losing their pension. Firefighters have the same bad-boy clause but it seldom applies.

3.7 Louisiana Teachers

About 1,800 Louisiana teachers elect DROP every year and slightly over half of the retirements have been by those who elected DROP. The system also noted that a handful of disabled members have returned to work just to join the DROP.

3.8 Milwaukee County

Milwaukee County implemented a back DROP in 2001. The plan covered general employees, had no limit on the number of post-NRD years that could be used to calculate the lump sum and used 8.5 percent to nine percent interest rates to determine DROP lump sums. The result was that some participants were immediately eligible for DROP lump sums that exceeded $1 million. The Milwaukee County DROP has been viewed by many as a pension scandal and more issues and lessons may emerge.