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7. Employer Issues

7.1 Cost Neutrality

A very common situation is that when an employer is first presented with a DROP proposal, the advocates argue that there is "no cost"[1]. It is just as common that the employer would give a preliminary go-ahead to look into a cost-neutral DROP option. However, this is where the complications discussed in "Section 4: Actuarial Issues" often cause reality to fail to live up to expectations. Initial plan designs may be found to actually increase the contribution rate. Next, plan designs may be changed to reduce or eliminate cost. However, disagreements may exist over how these changes should be valued.

Three common ways to reduce or eliminate DROP costs are (1) delay DROP eligibility, (2) reduce the percentage of the benefit added to the DROP account (e.g., 70% goes in the DROP account) or (3) eliminating COLAs during DROP period. These types of changes will reduce the cost of a DROP (either by reducing the number eligible or the benefit amount) but different sets of assumptions will produce different answers to the questions: (1) by how much? and (2) will DROP be cost neutral?

One of the most difficult questions for either the plan sponsor or the actuary to answer is the impact DROP will have on how long employees work. The plan sponsor should understand that if employees retire sooner, contribution rates will increase and if they work longer, contribution rates will decrease. A particular DROP cost estimate might be based on savings associated with employees who are assumed to work longer. We urge caution in this area

[1] We have used the vague term "no cost" (and "cost neutral" in the next sentence) since that is the degree of specificity given the argument by most non-actuaries. It then becomes the actuary's role to add the required specificity.

and refer back to the section on "Should the actuary assume that adding a DROP will delay when participants retire?" in Section 4.4. Sponsors should be aware of changes in retirement assumptions.

Many employers think that employer cost ends when a member retires or elects DROP. Some plans state on their Web site that both employee and employer contributions end when a member elects DROP[2]. This may indicate a fundamental misunderstanding of employer cost in a DB plan.

7.2 Estimating Non-Pension Cost/Savings

Estimating non-pension cost/savings is difficult. If adding a DROP is not expected to impact the length of time that an employee works, there is probably little to be done. If employees are expected to work longer due to the DROP, the reverse of the same types of questions that are often asked when considering a retirement incentive program should be asked. We have never seen a non-pension cost estimate that was any more than a good first approximation and subject to some criticism. However, factors to consider, include the following:

- Salary for continued employment of senior high paid employees
- Loss of promotional opportunities
- Non-pension benefit cost
- Deferred training cost
- Increase in internal efficiency due to keeping senior staff

Whether fortunate or not, in most cases the actuary is not involved in determining non-pension costs and sometimes the client does not care to have it measured.

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[2] Some plans may determine cost as a percentage of payroll, but simply removing the pay of DROP participants from the denominator increases the rate but does not affect the total cost.

7.3 Cost Uncertainty

Determining cost of benefits under a DB plan depends on a variety of assumptions and methods. Setting assumptions to determine the cost of adding a DROP feature is more difficult than most changes since the impact the retirement rates have on DROP cost is both material and uncertain. Some strategies to deal with this include:

- Make a "best estimate" of the cost (i.e., don't make the most conservative assumptions) and combine with a sunset provision and a scheduled review of the cost of the DROP. An example is the Dallas DROP that was reviewed after five years. The sunset provision allows the DROP to be a non-permanent part of the plan and limits unanticipated cost increases.

- Provide a maximum cost estimate. The maximum cost[3] might be that no one elects DROP and that all retire at NRD. A second "maximum" cost is that everyone elects DROP as soon as eligible and retires at the earlier of the current assumed retirement age or at the end of the maximum DROP period.

- Some DROP designs will result in a combination of DROP ratios above and below 100% (depending primarily on combinations of age and service). While individual choice will not solely be a function of the DROP ratio, it might be a good idea to identify where the ratio is under 100% and decide where it is appropriate to assume employees will make such elections that would not be in their favor. Finding low ratios is common when DROP can be elected at a reduced early retirement age.

7.4 Tax Treatment Uncertainty

In the mid-1990s there were few DROP plans and even fewer had IRS determination letters. Some plans (e.g., State of Maryland Police Retirement System) conditioned the implementation of their DROP on obtaining a favorable IRS ruling.

Beyond the broad concept of keeping the plan "qualified" are the detailed tax treatments, some of which may depend on individual plan designs. As was

[3] This could represent a material cost increase since anticipated gains from those that were expected to work beyond their NRA are lost (at least when determining the current contribution rate).

stated earlier, no one can predict how every legal issue about DROPs will be resolved, just as it would have been difficult in 1985 to predict legal issues for cash balance plans.

We believe that any public plan could adopt a DROP without material plan qualification problems. The plan sponsor may want to condition implementation on obtaining a favorable determination letter or other IRS opinion statement. However, many public sector plan sponsors intentionally avoid requesting a determination letter, sometimes arguing a lack of federal jurisdiction over their plans.

Beyond qualification is the issue of tax treatment. Both plan administrators (see IRC Section 402(f)) and employees require advice on how benefits can be rolled over or taxed. Often this comes in the form of formal or informal legal advice from the plan's legal counsel, possibly based in part on a private letter ruling from the IRS. New or unusual plan features (e.g., employee contributions continuing through retirement) often require extra legal consideration.

At this point we do not believe that tax treatment uncertainty should keep any public sector employer from adopting some type of DROP. Hopefully Section 5 covered most of the areas at issue. However, like any design to which the IRS has not provided regulations, more issues may emerge. Unusual features or taking the time to assure qualification and clarify issues should be handled prudently.

ERISA contains additional requirements that must be dealt with. A private-sector employer adding a DROP plan needs even more legal review than a public-sector employer. However, ultimately some type of DROP design is possible. See Section 8.1.

7.5 The Bargaining Process

Employer needs for employees at later ages

One of the real issues that employers need to address when considering adding a DROP feature is the existing retirement ages and "early" retirement subsidies. In the past an employer may have wanted to encourage early retirement. Whether the employer still does may differ for different groups of employees:

- Public safety employees have generally been allowed to retire early because of the physical requirements of their job. These physical requirements are still largely valid today. This early retirement age also kept many of these groups out of Social Security.

- School systems (like many large private sector employers) have seen their employment needs change (cycle) over time. This has made the desire to pay for large early retirement subsidies change.

A DROP can be a way to encourage employees to work longer (depending on how the DROP is designed). In a corporate/ERISA environment this can occur within a generation of employees by simply eliminating early retirement subsidies while protecting accrued benefits. This has often been criticized as being unfair to "current employees who have relied on them in retirement planning" (August 18, 2000 Testimony of Norman Stein, professor, University of Alabama to the ERISA Advisory Council). In the public sector this rarely happens since benefit protection usually extends beyond accrued benefits. A public-sector employer could set up a new "tier" of benefits that establishes a later retirement age for new employees. However, since the impact on employment might take 30 years (fewer years for plan cost), adding a tier does little to change employment patterns.

Adding a DROP has the potential for a more immediate change in employment continuation patterns. A sunset provision might deal with cycles in employment needs.

Cost neutrality perspectives

A second key issue is whether to assume employees will work longer thereby offsetting the cost of having the DROP ratio above 100%. Some actuaries prefer to design the DROP so that the ratio is very close to 100% and avoid changes in retirement rates. One article made the following points:

> While a well-designed DROP can be inexpensive to plan sponsors, it is also difficult to design a truly cost-neutral plan that is popular with employees. Those who expect to come out ahead financially are most likely to participate … the member's DROP account may be credited with pension payments that are less than 100% of the member's frozen benefit at the DROP date. This is often done to make the DROP cost-neutral. As a

result of this reduction, however, plan members may feel that they are being penalized for participating in the deferred retirement option plan.[4]

Perhaps not surprisingly, we have seen several instances where the plan actuary has accepted a definition of cost neutrally only when such designs (i.e. putting less than $1 into the DROP lump-sum account for every $1 of DROP annuity) were used to keep the DROP ratio at close to 100%. As predicted, these were not popular with employee groups.

Realities of collective bargaining

In one jurisdiction, a member of the employer's collective bargaining team presented to the County Council the following negotiated proposed changes to the firefighters' retirement plan:

1. Lowered the NRA (from 50 to 50 or 20 years at any age), and

2. Added a DROP feature

The question asked by the council was whether the aim of public policy was to encourage firefighters to retire younger or work longer? The bill was clearly at cross-purposes. The short answers were: (1) this is what was negotiated, (2) they can afford the changes and (3) they wanted comparability with police who already had 20 & out and were getting a DROP. The point is that what the employ<u>er</u> wants and what the employ<u>er</u> will agree to may be two different things.

Many non-actuaries have incorrectly assumed that adding a DROP will "save the employer costs simply by eliminating any pension accrual during the DROP period and no longer being required to fund the benefit." Often one of the first steps in the bargaining process is correcting both sides' understanding on this issue.

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[4] Norman L. Jones and Judith A. Kermans, Gabriel, Roder, Smith & Company; *Plan Sponsor* April 1999, "Before you DROP: A guide for public plans".

7.6 Promotional Opportunities

If adding a DROP encourages senior employees to work longer, it will also limit promotional opportunities. This is usually a concern of younger employees. It may also be a concern for those looking for promotional opportunities for minorities and women who may have less seniority.

7.7 Phase-in of Coverage

One concern is that if an initial cohort signs up at the same time they will also retire at the same time. This may cause problems with staffing and training. This is sometimes dealt with by staggering the entry into DROP. For example, the number that can enter DROP in any given month is limited to a fixed number with selection based on seniority.

7.8 Human Resources Issues

Employers may find the following advantages to DROPs:

- Retains experienced employees.

- Provides relatively fixed retirement dates that can be used to plan when new hires are needed. However this would not be true for either (1) a back DROP or (2) a forward DROP with an unlimited DROP participation period.

7.9 Why Trustees Might Like DROP

Trustees need to deal with the administrative issues of running a DROP plan, but these are often offset by the following:

- Both employers and employees like DROPs

- Adding a DROP will reduce the pressure to eliminate their plan and replace it with a DC plan

- The addition of DROP may be viewed as progressive

7.10 Mandatory Retirement

It is beyond the scope of this paper to decide whether or not a DROP participant can be forced to retire at the end of the DROP period. Generally, those DROPs that require employees to retire at the end of a fixed period of time write the DROP election form, in part, as a voluntary resignation letter with a delayed effective date. This is often an irrevocable election (after a short "cooling off" period). Plan counsel can usually get the election forms used by other DROP plans as a starting point when: (1) drafting a specific plan's forms and (2) considering the legality of these provisions. To the best of our knowledge there has been no legal challenge to the mandatory retirement provision by an employee that has decided they did not want to retire.