



*addressing public pension issues of today
...AND TOMORROW*

Public Safety Employees Pension & Benefits Conference

Public Perceptions of DROP and
Public Safety Pensions: Problems
& Solutions

DROP – Deferred Retirement Option Programs

A much maligned, but valuable and beneficial tool

IF

Cautiously & properly designed and managed

Overview – Where are we going?

1. Sources & Case Studies of Negative Publicity
2. Cost Pitfalls and Other Problems with DROP
3. “Golden Rules” of DROP Design
4. Addressing the Cost-Neutrality Dilemma
5. Public Perception of DROP
6. Benefits of DROP
7. Positive Case Study

Sources & Case Studies of Negative Publicity

- Unfortunately, DROP has had some negative publicity:
 - Quote from front-page NYT article (by Mary Williams Walsh)
 - “DROP’s have been abused again and again by naïve or self-interested officials, who have pumped up benefits well beyond what the rank and file expected or what the pension fund could pay.” - Ouch
- Case Studies – what went wrong?
 - Milwaukee
 - Houston
 - San Diego

Sources & Case Studies of Negative Publicity

■ Milwaukee

- Felony conviction for Personnel Director for stating in memo that DROP would be cost neutral
- Back-DROP
 - What is a Back DROP?
- Even worse, unlimited Back DROP
- High interest rate credit (9.0%!?!)
- Large lump sums (PR problem)
- Non-safety employees
- Bad assumptions (low participation assumption compounds impact of cost underestimation)

Sources & Case Studies of Negative Publicity

■ Houston

- High interest rate credit (8.5%)
- Large lump sums (PR problem)
- Non-safety employees
- Cash flow crunch
- Low DROP participation assumption compounds cost underestimation

■ San Diego

- Attention on DROP magnified by increased focus on pension system because of other funding problems
- Similar problems as Houston (high interest – 8%, non-safety, large lumps sums, etc.)
- Likely that DROP will be dropped

Cost Pitfalls and Other Problems with DROP

- What do these and other problematic DROPs have in common?
 - High Interest Rate Credits
 - Under DROP, rather than reasonable, low
 - Have seen proposed DROP where interest = higher of plan return or 8%, when assumed plan return was only 7.25%
 - Under DROP, plan responsible for financial risk while DROP deposits being made, unlike regular annuity benefit paid to participant

Cost Pitfalls and Other Problems with DROP

- Enable participants to elect against the soundness of the Plan – Antiselection
 - “BackDROPs, etc.”
- DROP length
 - Long maximum and/or minimum DROP periods (or even unlimited) can generate massive lump sums. This can create bad PR, even if the DROP is otherwise well-designed and lengthy period of DROP more effective in extending service, which is potential benefit to jurisdiction

Cost Pitfalls and Other Problems with DROP

- Final Average Salary issues
 - Spiking of salaries (through overtime, sick leave, longevity) at end of career can create larger than expected benefits
 - DROP doesn't create the issue, but can magnify in public's eye through large lump sums
- Payroll Issues
 - Impact on payroll from longer-service employees can exceed impact on pension plan

Cost Pitfalls and Other Problems with DROP

- Promotional Opportunity Issues
 - Less senior employees have expressed dismay at fewer promotional opportunities caused by extended senior service from DROP
- Negative investment return could hurt employees
- Makes life hard for Actuaries!
 - Just kidding (sort of)
 - Complicates plan, assumptions
 - Make sure your actuaries are using reasonable assumptions to value DROP plans
 - May be advisable or necessary for actuary to provide range of possible costs rather than fixed cost estimate

“Golden Rules” of DROP Design

- Safety Employees Only!
 - General EE's can have extremely high paid individuals who would get huge lump sums
 - Different demographic concerns for General EE's - DROP not necessarily best solution
- Use Conservative Interest Credit
 - Could use credit tied to bond returns
 - Or, use fixed rate lower than assumed return on assets
- Avoid antiselection (such as “BackDROP”)
- Avoid extremely long DROP periods
 - Eliminates large lump sums and associated PR problems

Addressing the Cost-Neutrality Dilemma

- Why is it difficult to make DROP cost neutral?
 - By their nature, DROPs represent a preservation of early retirement subsidies (implicit in 20&Out or 25&Out retirements) for those who choose to continue working
 - Therefore, adding DROP (without offsetting provisions) normally results in cost increase, unless:
 - Everyone currently retires when first eligible (not typical, esp. for fire), or
 - Presence of large late-career pay raises or benefit accruals

Addressing the Cost-Neutrality Dilemma

- If cost-neutrality desired, can use offsetting provisions to counteract effect of employer subsidy preservation
 - Using low(er) interest rate credits
 - Use partial DROP benefit credits
 - DROP credit < 100% of retirement benefit
 - Forego COLAs during DROP
 - No disability or survivorship type death benefit during DROP
 - Higher employee contributions due to shorter funding period

Addressing the Cost-Neutrality Dilemma

- Finally, even if DROP projected to be cost-neutral, no guarantee that it will be in actuality
 - Again, may be advisable for actuary to provide range of potential costs, instead of implying anticipated cost-neutrality
- Favorite quote about actuaries – “We’re always wrong”
 - Actual cost determined by actual experience, projected cost based on uncertain assumptions about future
- Even if DROP is actually cost neutral, virtually impossible to verify this after the fact

Public Perception of DROP

- What is the Public Perception as to why DROP should not be offered?
 - We lowered the retirement age based on the complaint that safety members should not be required or encouraged to work past 45-50 in a job which required vigorous and youthful service delivery
 - DROP encourages these members to stay on by preserving the early retirement subsidies to later ages

Public Perception of DROP

- Other Issues
 - Large lump sums
 - Especially when private sector employees have seen 401(k) balances battered
 - “Double-Dipping”
 - Must explain clearly that benefits have already been earned – would have been paid anyway if employee had retired
 - “Triple-dipping” – some jurisdictions have had to rehire post-DROP retirees because of lack of qualified replacements
 - Public Officials designing own benefits
 - Help avoid this by making DROP safety-only

Benefits of DROP

- Why is DROP desirable to the public jurisdiction?
 - Need to communicate this effectively
 - Enables Jurisdiction to keep senior/key employees without enabling higher salaries to be pensionable
 - Save on training, retiree medical, and other costs
 - Efficiency/Productivity of experienced employees
 - Sparcity of new hires

Benefits of DROP

- Can potentially have cost savings, if ...
 - Conservative design (interest rate, % of benefit, etc),
 - Current benefit has high back-loading characteristics, such as large, late pay raises, or
 - Lower disability costs
 - Can have lower costs if currently experiencing high disability rates near NRA
 - Replace disability benefits with DROP
 - Still ensure adequate benefit for members who become disabled late in career

Positive Case Study - Dallas

- DROP plan put in place in 1993
 - Unlimited forward DROP
 - Five-year follow-up study in 1997
 - Actuary says basically cost-neutral (maybe even cost-savings)
 - Average retirement age increased (from 52.4 to 57.7)
 - Material decline in disabilities
 - DROP participation rate almost 100%
 - Some concern from younger members regarding promotional opportunities

Conclusions – Where have we been?

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