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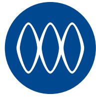

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Considering a DROP? A PLOP May Fit Better

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With the recent press concerning the surprising cost effects of what were intended to be "cost-neutral" Deferred Retirement Option Plans (DROPs), now is a good time to revisit DROPs and how they affect retirement decisions. Further, this article will discuss how a Partial Lump-sum Option Plan (PLOP) could be a better fit for employees, employers, and the pension plan.

DROP Basics

DROPs have been discussed thoroughly in publications and at many conferences for well over 10 years. Basically, DROPs attempt to entice retirement-eligible employees to delay retirement in exchange for a significant lump-sum amount upon their termination along with the monthly annuity that would have been paid without delaying retirement. The typical DROP allows the employee to have their retirement benefit calculated at DROP entry (so future service or pay increases are ignored) and then establish an account for the sole purpose of accumulating the benefits during the DROP period (usually not more than three to five years). During the DROP period, the employee's DROP account would be credited with all or a percentage of the monthly retirement benefit, rather than the benefit being paid directly. Depending upon the features of the DROP, the account may also be credited with interest and cost of living adjustments (COLAs). This account is then paid to the member at the end of employment, and the monthly annuity (as previously determined) commences.

There are two basic types of DROPs: a forward DROP, which typically requires an irrevocable election on the part of the employee to enter; and a back-DROP, which allows the member to apply for the DROP retroactively. The features of DROPs (i.e., eligibility, DROP period length, percent of benefit credited to DROP account, interest credits, COLA credits, etc.) vary widely and have a significant impact on the attractiveness of the DROP to employees and the effectiveness changing the retirement behavior desired by employers.

DROP plans appeal to employees in two situations. First, some plans have a cap on service that is recognized. Employees working beyond that point sometimes ruefully note that they could be earning 50%-75% of their current pay without working—or they take the benefit and go work somewhere else. The DROP reduces this employment disincentive by providing some or all of the foregone pension. Second, many people like the idea of a large lump sum of money at retirement. The lump sum amount accumulated in a typical DROP could well exceed what they accumulated in a deferred compensation program over an entire career. This appeal to employees gives employers a tool to retain experienced employees.

DROP Difficulties

The anticipated impact of a new DROP depends largely on the expected utilization and behavior of retirement-eligible employees. If actual experience differs materially, the DROP may result in actuarial gains or losses to the plan and could impact employer-required contributions. If actuarial losses result, the DROP features are sometimes amended and may reduce the incentives for employees to elect a DROP, which, in turn, decreases the DROP's utilization and effectiveness. Ultimately, a DROP with 0% utilization is certainly cost neutral, but it also accomplishes none of the employer's goals.

An employee who irrevocably elects a forward DROP can end up with a total value of retirement benefits less than they otherwise may have earned with additional service credits and pay increases, particularly if the employee's compensation is significantly increased during DROP due to a promotion or major pay scale increase. A back-DROP avoids this problem because employees are allowed to choose either their regular retirement benefit or the back-DROP benefit determined as if they elected DROP at some prior date. This ability to elect the most valuable benefit is why back-DROPs generally increase a plan's costs. A response to the cost impact of the typical back-DROP is an actuarially equivalent back-DROP, which, in essence, is a PLOP.

An analysis of the total employer cost of such a plan needs to consider the range of possible utilization and behavior of retirement-eligible employees. This should include not only the impact on the pension plan, but also the change in total payroll, medical benefits, and other employment costs.

Beyond the actuarial concepts associated with DROPs there are two other issues to consider. First, DROP programs sometimes are presented in the press as a form of windfall or double-dipping. Second, while a DROP may help address employment issues in the present environment, the future may call for a different tactic. Consequently, a sponsor may wish to set up the DROP with a sunset date to avoid any contractual agreement issues.

PLOP Basics

A PLOP is an easily administered optional form of benefit. An eligible employee may elect the amount of benefit to be paid in a lump sum (usually the total of a number of months of their accrued benefit or a percentage of the present value of their benefit) and the employee's monthly retirement benefit is actuarially reduced to reflect the lump sum payment. The remaining monthly benefit can be further adjusted for other optional forms of benefit payment. Typically, the PLOP lump sum is limited to the member's accumulated contributions with interest, the total of 24 or 36 monthly payments, or 25% or 50% of the total present value of the employee's retirement

benefit. Regardless, the actuarial equivalent nature of this option means no material impact on plan liabilities.

Like a DROP, a PLOP can be used as a tool by employers to either retain retirement-eligible employees or entice earlier retirements simply by adjusting the PLOP eligibility requirements. An example is a PLOP that requires additional service beyond an employee's normal retirement date in order to become eligible for the PLOP. Under a PLOP, the value of an employee's benefit is based upon all credited service and salary earned through the actual date of retirement, so salary increases through promotion or bonuses will typically increase their retirement benefits, and in turn, the lump sum amount available from a PLOP. In this way, a PLOP could be a better fit for an employer's desire to maintain an experienced and motivated workforce.

TABLE 1

Comparison of Approximate Lump Sums Available Under DROP and PLOP

Eligible to Retire or DROP at age 55 ...	2-Year PLOP	3-Year PLOP	Entered DROP at age 55
..and work to age 58	$113,000	$169,000	$145,000
..and work to age 59	$122,000	$183,000	$201,000

Bases: Plan–2.5% of final average pay per year of service, rule of 80 normal retirement; PLOP –allows 24 or 36 months paid in a lump sum at retirement; DROP–typical forward DROP with 4 year maximum DROP period; Actuarial assumptions–7.75% interest, 1994 GAM Table, annual salary increase of 4.75%, no COLA, 7.25% interest credited to DROP quarterly; Participant–Male, hired at age 30, final average salary of $70,000 at age 55.

Comparison of Available Lump Sums

Table 1 is an illustrative comparison of the approximate lump sum amounts available from a fire and police plan with a typical forward DROP and a typical PLOP. A significant lump sum amount is a feature found attractive by employees and both options provide a significant lump sum amount. While the DROP lump sum amounts are higher, the monthly benefits under the DROP would typically be lower.

Risk Considerations

The primary difference between a DROP and a PLOP is risk. With most DROPs the employer risks additional pension cost while the employee risks a reduction in the value of retirement benefits. Those DROP provisions that work toward mitigating the risk to employers typically increase the risk for employees. The employer's risk associated with implementing a DROP is lower where the plan's assumption for unreduced retirement eligiblity already places the associated probability at or near the age and service criteria being considered for DROP entry, although future experience gains might be lost. An example is a plan with normal retirement at 25 years of service regardless of age. If the actuarial assumption for normal retirement (before a DROP is added) is 100% elect to retire at 25 years of service, the plan liability associated with normal retirement is already considering the most expensive case. If a DROP could instead be elected at 25 years of service, the initial contribution change may be 0. However, the true cost is the future reduction in actuarial gains—a number that may be difficult to estimate with confidence. This profile is more common in small to medium-sized plans where retirement assumptions are conservatively set. It is no coincidence that many of the early DROPs fit this profile.

For plans where the normal retirement assumption already considers a likelihood of employees working beyond normal retirement eligiblity, there is an increased risk of additional employer cost. This risk is primarily due to the effect that DROP can have on retirement, particularly when the assumption had been that employees work well past their initial unreduced retirement date. For example, employees who had planned to work three years past normal retirement eligibility (perhaps to allow a child to finish college) now enter a three-year DROP at normal retirement age. If the assumptions of the plan anticipated that employees work three years beyond normal retirement eligibility, the plan likely incurs greater cost and the employer gains no additional service with the DROP. If the desire is to implement a cost-neutral DROP, the design necessary to achieve cost neutrality may decrease the percent of monthly benefit and/or the interest credited to the DROP. These design changes may reduce the expected cost impact of the DROP but they alternatively increase the risk to the employee of ending up with less in total benefit value than they may otherwise have earned had they not elected DROP.

A PLOP is not entirely without risk. Like a DROP, a highly utilized PLOP can place a strain on cash flow, which should be assessed and monitored under either option. Also, like a DROP, a PLOP accelerates the payment of benefits and can increase the amount of payments made to retirees who die earlier than expected. To the extent that retirees who are in poor health elect the PLOP and those in better health decline it, there would be some increased costs. Limiting the portion of the benefit that can be taken through a PLOP helps limit this impact. These risks are manageable with routine monitoring of trends through experience analysis and cash flow testing.

Conclusion

A PLOP is a true optional form of benefit rather than a plan design feature. As an optional form, a PLOP may be easier to add or adjust, and is often simpler to explain.

Many employers will consider a DROP as an inducement for retaining experienced employees, others as adding choice for employees for the distribution of retirement benefits, and still others as a competitive benefit design. Regardless of the reason, a PLOP should be considered as a less risky—and potentially lower cost—alternative.

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