



EXECUTIVE CHAMBERS

HONOLULU

LINDA LINGLE
GOVERNOR

January 5, 2004

The Honorable Calvin K. Y. Say, Speaker
and Members of the House of Representatives
Twenty-Second State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear Mr. Speaker and Members of the House:

For your information and consideration, I am transmitting herewith (2) copies of the Employees' Retirement System (ERS) studies in accordance with House Concurrent Resolution No. 95 which was adopted by the Twenty-Second Legislature of the State of Hawai'i, Regular Session of 2003. Pursuant to Act 231, Session Laws of Hawai'i 2001, I am also informing you that the report may be viewed electronically at www.state.hi.us/budget.

Sincerely,

/s/

LINDA LINGLE

Enclosures



EXECUTIVE CHAMBERS

HONOLULU

LINDA LINGLE
GOVERNOR

January 5, 2004

The Honorable Robert Bunda, President
and Members of the Senate
Twenty-First State Legislature
State Capitol, Room 003
Honolulu, Hawaii 96813

Dear Mr. President and Members of the Senate:

For your information and consideration, I am transmitting herewith (2) copies of the Employees' Retirement System (ERS) study in accordance with House Concurrent Resolution No. 95 which was adopted by the Twenty-Second Legislature of the State of Hawai'i, Regular Session of 2003. Pursuant to Act 231, Session Laws of Hawai'i 2001, I am also informing you that the report may be viewed electronically at www.state.hi.us/budget.

Sincerely,

/s/

LINDA LINGLE

Enclosures



GABRIEL, ROEDER, SMITH & COMPANY
Consultants & Actuaries

5605 N. MacArthur Blvd. • Suite 870 • Irving, Texas 75038-2631 • 469-524-0000 • fax 469-524-0003

December 31, 2003

Mr. David Shimabukuro
Administrator
State of Hawaii Employees' Retirement System
City Financial Tower
201 Merchant Street
Honolulu, HI 96813-2980

Dear David:

**Subject: Report on Deferred Retirement Option Plan as Requested by House
Concurrent Resolution No. 95**

House Concurrent Resolution No. 95 requested the Employees' Retirement System (ERS) to undertake a study to determine the feasibility of a Deferred Retirement Option Program (DROP) for Firefighters and Police Officers. The resolution also states that if it is determined that a DROP is feasible then ERS should (in conjunction with other entities) provide model language to effectuate the Plan. A copy of HCR No. 95 is attached to this letter for your reference.

Requested Study

The Board of Trustees for the ERS requested that Gabriel, Roeder, Smith & Company (GRS) perform a study to determine the feasibility of a DROP for the Firefighters and Police Officers covered under the ERS. After discussions between GRS and the Board regarding DROP design issues, the Board requested that the DROP design include the following features:

1. The DROP design should be "cost neutral" to the employers;
2. Eligibility for DROP occurs at eligibility for unreduced retirement benefit;
3. No member contributions during DROP;
4. Employer contributions continue during DROP;
5. No interest credited to the DROP account;
6. No post retirement benefit (PRB) increases during DROP, but PRB's are caught up at actual retirement;
7. 5-year maximum DROP participation;

The Board requested that two alternative designs be looked at for obtaining cost neutrality. The first design achieves cost neutrality by adjusting the percentage of the DROP benefit that is credited to the DROP account. The second design credited 100% of the members' DROP benefit to their DROP account but required a minimum number of years of DROP participation or the DROP account would be forfeited. The scope of the study was limited to these two designs and did not include a search for more attractive designs if these designs were not feasible.

Summary

In conjunction with determining the cost implications of the DROP designs GRS also prepared a PowerPoint presentation that discusses many of the issues that are involved with DROP programs including plan design features, cost impact issues, and other pertinent items. A copy of this presentation is attached to this letter.

As may be seen on slide 42 of the presentation, under the first plan design only 30% of a Firefighter or Police Officer's DROP benefit may be credited to the DROP account if cost neutrality is to be achieved. Slide 44 shows that even requiring Firefighters and Police Officers to remain in DROP for a minimum period of 5 years did not achieve cost neutrality for ERS under the second plan design. Increasing the minimum stay period may produce cost neutrality, but the minimum 5-year period is already an unattractive design and increasing the minimum period would just make it less attractive.

Recommendations for ERS

Based on the DROP design features that were included at the request of the Board neither of the alternatives for creating a cost neutral DROP produce a DROP program that is feasible. We would therefore recommend that neither of the designs be implemented. It may be possible that the DROP design could be adjusted to produce a feasible DROP program that is cost neutral to the State and county government employers, however as stated earlier, determining those possible design features was beyond the scope of this project.

Other Comments

If the Board decides to continue studying other possible DROP designs, we would suggest that in order to achieve cost neutrality and provide a feasible DROP program the Board should look at having member contributions continue during the DROP period. Also, delaying the eligibility for DROP to some point past the eligibility for unreduced retirement may also produce more desirable results.

As requested by the Board the PowerPoint presentation also shows cost neutral designs for the other members of ERS. It should be noted that the current DROP designs did not produce a feasible DROP program for the other employee groups covered under ERS either.

Mr. David Shimabukuro
December 31, 2003
Page 3

After reviewing this report, please contact us if you have any additional questions or comments.

Sincerely,

Gabriel, Roeder, Smith & Company



W. Michael Carter, FSA
Senior Consultant



Lewis Ward
Consultant

kb

c: Rick Roeder, Gabriel, Roeder, Smith & Company

j:\3046\2003\Drop\DROP_Summary Letter.doc

HOUSE CONCURRENT RESOLUTION

REQUESTING THE EMPLOYEES' RETIREMENT SYSTEM TO STUDY THE
FEASIBILITY OF A DEFERRED RETIREMENT OPTION PLAN BENEFIT
FOR FIRE FIGHTERS AND POLICE OFFICERS.

1 WHEREAS, acquiring and retaining well-trained employees
2 contribute to the efficiency of government; and

3
4 WHEREAS, both in the private and public sector, pension
5 benefits are often a major consideration for employees both in
6 initially accepting employment and in remaining in certain
7 positions; and

8
9 WHEREAS, enhancing public sector pension benefits may help
10 improve recruitment and retention of fire fighters and police
11 officers; and


12
13 WHEREAS, the retention of fire fighters and police officers
14 continues to be an ongoing concern for the counties and their
15 respective fire and police departments; and

16
17 WHEREAS, in addition to being responsible for fire
18 suppression, fire fighters are also first responders, rescue
19 specialists, and HAZMAT specialists, and perform a plethora of
20 other duties and assignments to protect and serve the community;
21 and

22
23 WHEREAS, fire fighter's and police officer's retirement
24 benefits are based on 2.5 per cent for each year of credited
25 service; and

26
27 WHEREAS, fire fighters and police officers currently
28 contribute 12.2 per cent of their wages to the Employees'
29 Retirement System; and

I do hereby certify that the within document
is a full, true and correct copy of the original
on file in this office.


Chief Clerk
House of Representatives
State of Hawaii

1 WHEREAS, fire fighters, police officers, and other public
2 safety officers are eligible to retire after 25 years of
3 credited service with no age requirement; and

4
5 WHEREAS, a deferred retirement option plan (DROP) is an
6 incentive for fire fighters and police officers to stay beyond
7 the requisite 25 years of service and continue to protect the
8 community and maintain the highest level of quality of the
9 departments; and

10
11 WHEREAS, DROP allows a member to defer pension benefits
12 which they are eligible for upon the requisite years of service
13 into a separate account and that account is separate from the
14 contributions made by an employee based on earlier years of
15 service; and

16
17 WHEREAS, once enrolled in DROP, the employee's retirement
18 pension is determined based on the years of credited service at
19 the time the employee enrolls in the DROP and additional years
20 of service is not eligible for credit; and

21
22 WHEREAS, DROP is increasingly being utilized in many states
23 and municipalities such as Arizona, Ohio, Florida, the City of
24 Philadelphia, the City of Los Angeles, and Baltimore County; and

25
26 WHEREAS, the Employees' Retirement System of the State of
27 Hawaii (ERS) works with one of the nation's most experienced
28 actuarial firm in the field of public employee pension funds and
29 has the resources to conduct such a feasibility study; now,
30 therefore,

31
32 BE IT RESOLVED by the House of Representatives of the
33 Twenty-second Legislature of the State of Hawaii, Regular
34 Session of 2003, the Senate concurring, that the ERS, in concert
35 with the ERS contracted actuary firm, the affected human
36 resources agencies, public safety department representatives,
37 the Hawaii Fire Fighters Association (HFAA) and the State of
38 Hawaii Organization of Police Officers (SHOPO), is requested to
39 study the feasibility of a DROP benefit for public safety
40 employees; and

1 BE IT FURTHER RESOLVED that if this study determines that a
 2 DROP benefit for public safety employees is feasible, then to
 3 make recommendations for the establishment of such a program;
 4 and

5 BE IT FURTHER RESOLVED that the ERS, along with the
 6 affected human resources agencies, public safety departments,
 7 HFAA, and SHOPO work to develop model language to effectuate the
 8 plan; and

9 BE IT FURTHER RESOLVED that the study be concluded and the
 10 results and any model legislation be presented to the House
 11 Committee on Labor and Public Employment and Senate Committees
 12 on Labor and Health and Human Services no later than 20 days
 13 prior to the convening of the Regular Session of 2004; and

14 BE IT FURTHER RESOLVED that the Legislature review the
 15 recommendations and consult with independent parties and
 16 industry experts with regard to any modifying legislation; and

17 BE IT FURTHER RESOLVED that certified copies of this
 18 Concurrent Resolution be transmitted to the Administrator of the
 19 Employees' Retirement System, Mayors of the City and County of
 20 Honolulu, County of Hawaii, County of Maui, and County of Kauai,
 21 directors of the affected human resources departments, Police
 22 and Fire Chiefs of all counties, HFAA, and SHOPO.

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 29

OFFERED BY: *Paula Oaki*
[Signature]
[Signature]
 Kirk Caldwell
[Signature]
 MAR 11 2003

STAND. COM. REP. NO. 1653

Honolulu, Hawaii
April 25, 2003

RE: H.C.R. No. 95

Honorable Robert Bunda
President of the Senate
Twenty-Second State Legislature
Regular Session of 2003
State of Hawaii

Sir:

Your Committee on Labor, to which was referred H.C.R. No. 95
entitled:

"HOUSE CONCURRENT RESOLUTION REQUESTING THE EMPLOYEES'
RETIREMENT SYSTEM TO STUDY THE FEASIBILITY OF A DEFERRED
RETIREMENT OPTION PLAN BENEFIT FOR FIRE FIGHTERS AND POLICE
OFFICERS,"

begs leave to report as follows:

The purpose of this measure is to request that the Employees'
Retirement System (ERS), an ERS-contracted actuary firm, the
affected human resources agencies, public safety department
representatives, the Hawaii Fire Fighters Association, and the
State of Hawaii Organization of Police Officers study the
feasibility of a deferred retirement option plan benefit for
public safety employees.

Testimony in support of this measure was submitted by the
Hawaii Fire Fighters Association. The Employees' Retirement
System submitted comments on the measure.

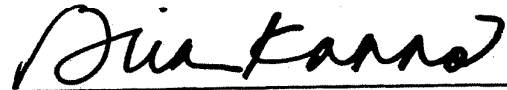
Your Committee finds that deferred retirement option plans
(DROPs) have been established in other states and municipalities,
and warrant further consideration. A typical DROP allows eligible
employees to "retire" on paper. Employers no longer make
contributions to the ERS on behalf of the member and the member
stops making the 12.2 percent contribution to the ERS. The
member's retirement benefit allowance is calculated based on the
date of enrollment, and no additional years of service will be
credited to the calculation of the retirement allowance. The



amount that is entitled to the member at the time of enrollment of the plan will be placed into a deferred retirement plan. DROPs may help with the recruitment and retention of public safety employees, and may result in savings for the employer during the DROP period.

As affirmed by the record of votes of the members of your Committee on Labor that is attached to this report, your Committee concurs with the intent and purpose of H.C.R. No. 95, and recommends its adoption.

Respectfully submitted on
behalf of the members of the
Committee on Labor,



BRIAN KANNO, Chair



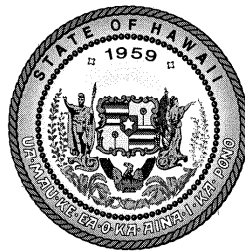
The Senate
 Twenty-Second Legislature
 State of Hawaii

Record of Votes of the
 Committee on Labor
 (Bills and Resolutions)

Measure:* <i>HR 95</i>	Committee Referral: <i>LBR</i>	Date: <i>4/17/03</i>		
<input type="checkbox"/> The committee is reconsidering its previous decision on this measure. If so, then the previous decision was to: _____				
The Recommendation is to: <input checked="" type="checkbox"/> Pass, unamended <input type="checkbox"/> Pass, with amendments <input type="checkbox"/> Hold <input type="checkbox"/> Recommit				
Members	Ayes	Ayes(WR)	Nays	Excused
KANNO, Brian (C)	✓			
IHARA, Les, Jr. (VC)	✓			
KAWAMOTO, Cal	✓			
SAKAMOTO, Norman				✓
TANIGUCHI, Brian T.				✓
SLOM, Sam	✓			
TOTAL	<i>4</i>	<i>0</i>	<i>0</i>	<i>2</i>
Recommendation: <input checked="" type="checkbox"/> Adopted <input type="checkbox"/> Not Adopted				
Chair's or Designee's Signature: <i>[Signature]</i>				
Distribution: Original - Committee Yellow - Clerk's Office Pink - Drafting Agency				

*Do not list more than one measure per Record of Votes.

**Employees' State Retirement
System of the State of Hawaii**



**Consideration of a Deferred Retirement
Option Program**

December 2003



Items To Be Covered

- **Review of why DROP**
- **What is DROP?**
- **Items affecting cost of DROP**
- **Administrative considerations**
- **Other alternatives to DROP**
- **Case studies**
- **Two alternatives for cost neutrality**
- **Actuarial analysis of the two alternatives**
- **Closing comments**



Review of Why DROP?

- **DROPs have become very common**
- **But there is no standard DROP design**
- **Most popular with uniformed officer plans**
- **DROPs exist in at least 11 state plans**
- **Many local plans have DROPs**
- **Originally intended to encourage deferring retirement**
- **Lump sum availability sometimes appears to be most important feature**



Review of Why DROP? (cont.)

- **DROPs may actually allow accrual of higher benefit than the basic formula**
- **DROPs can give the appearance of a defined contribution type of benefit**
- **Unless carefully designed, DROPs usually are not cost neutral**



What is DROP?

- **Derred Retirement Option Program**
 - **Optional program**
 - **Eligible members elect to freeze their regular retirement benefit and have a portion of that benefit credited to a special (nominal) account within the retirement plan**
 - **Members in DROP continue to work and draw a salary from their employer**



What is DROP? (cont.)

- **Accumulated amounts credited to the member's account during DROP are withdrawn by the member after termination of employment**
- **Upon termination of employment, members also begin to receive the frozen regular retirement benefit**
- **At its most fundamental level, DROP is a special partial lump-sum option available at retirement**
- **DROP is not necessarily cost neutral**



What is DROP? (cont.)

- **So far, the cash flow implications of DROP have not been extensively studied**
- **Most plans with DROPs experience high utilization by eligible members**
 - **80% - 95% election rates are not unusual**
- **DROP does not work well unless it is tied to eligibility for an unreduced retirement benefit and tied to the ultimate benefit multiplier if the multiplier increases as years of service increase**





Items Affecting Cost of DROP

- **Design of basic retirement plan**
- **Design of the DROP itself**
- **Demographics and characteristics of the membership**
- **How members react to DROP**
- **Administrative considerations**



Basic Retirement Plan Design Issues Affecting Cost

- **Benefit structures**
 - **Uniform benefit multiplier for all years of service**
 - **Same benefit multiplier for both reduced and unreduced retirement**
- **Presence or absence of automatic COLAs**
- **Normal form of benefit**
 - **Straight life**
 - **Joint and survivor annuity**
- **Retirement eligibility provisions**



DROP Design Issues Affecting Cost

- **Date of first eligibility for DROP**
 - Only if eligible for normal (unreduced) retirement
 - If eligible for either normal or early (reduced) retirement
- **Eligibility for death and disability benefits during DROP service**
 - Still applicable during DROP service
 - No longer available if in DROP



DROP Design Issues Affecting Cost (cont.)

- **Handling of member contributions during DROP service**
 - **Continue member contributions**
 - **Cease member contributions**
- **Handling of employer contributions during DROP service**
 - **Continue employer contributions**
 - **Cease employer contributions**
 - **Hawaii's approach of calculating a dollar amount to be contributed does not lend itself to ceasing employer contributions during DROP**



DROP Design Issues Affecting Cost (cont.)

- **Rate of interest, if any, credited to DROP account**
- **Revocable versus irrevocable election to enter DROP**
- **Whether or not the regular benefit applies as a minimum**
 - **Especially pertinent if member contributions continue**
- **Handling of COLAs during DROP**
 - **COLAs are applied to the frozen DROP benefit**
 - **COLAs are not applied to the frozen DROP benefit**
 - **Whether COLAs are caught up after actual retirement**



DROP Design Issues Affecting Cost (cont.)

- **DROP payment options**
 - **Lump-sum and whether eligible for roll-over**
 - **Periodic payout over a fixed number of years**
 - **Annuitize the DROP balance into a lifetime income to be added to the frozen DROP benefit**



Other Items Affecting Cost

- **Actual ages at entry into DROP**
- **Actual retirement patterns**
 - **No change before and after DROP**
 - **Earlier actual retirements after DROP**
 - **Later actual retirements after DROP**
 - **Especially pertinent if employer contributions continue**
- **What happens at end of DROP period if the member is not ready to actually retire**



Other Items Affecting Cost (cont.)

- **Relative relationship between member and employer contribution rates**
 - **Especially if member contributions cease but employer contributions continue**
- **How long the member stays in DROP**
- **Percentage of the benefit credited to DROP account**
- **Options available for payment of DROP account**
- **Handling of service purchase and sick leave/vacation pay credits vis-à-vis DROP participation**



General Observations on the Cost of DROP to System

- **Cost of DROP generally increases as the age at DROP entry increases**
- **If DROP results in delaying actual retirement, cost of DROP decreases (and may actually save money)**
 - **No hard evidence it delays the retirement decision in the absence of inducements in DROP design to encourage the DROP participant to defer actual retirement**
- **If employer contributions cease during DROP, DROP's cost increases as the years in DROP increase**



General Observations on the Cost of DROP to System (cont.)

- **If employer contributions continue during DROP, the number of years in DROP generally has no material adverse cost consequences**
 - **But there may be human resource or plan administration reasons to limit the number of years**



Administrative Considerations

- **DROP requires additional record keeping functions**
- **Data items to be stored and tracked include**
 - **DROP eligibility and length of time in DROP**
 - **DROP account credits and balances**
 - **Frozen retirement benefit**
 - **Form of payment of DROP distribution**



Administrative Considerations (cont.)

- **Administrative software will need to be updated to accommodate DROP**
- **Administrative personnel will need to be trained**
 - **DROP provisions**
 - **Administrative software**
- **Communication with members**
 - **Summary description, etc. at outset of DROP implementation**
 - **On-going communication in day-to-day DROP administration**



DROP Advantages/Disadvantages to Member

Advantages

- Partial lump-sum
- Pay decrease “indifference” to pay changes
- Elimination of contributions*

* Some DROP designs

Disadvantages

- No future accruals or COLAs on them
- No benefit improvements
- Pay increases not reflected
- Lower income replacement if DROP lump sum isn't considered
- DROP was wrong decision if significant post-DROP salary increases



DROP Advantages/Disadvantages for Retirement System and Employer

Advantages

- Additional benefits at no cost* or at modest cost
- Possible delayed retirements

Disadvantages

- Complex administration
- Antiselection/cost neutrality difficulties
- Lack of employee contributions*

* Some DROP designs



A Possible DROP for ERS

- **A percentage of the frozen benefit will be credited to DROP account**
- **No member contributions during DROP**
- **No interest credited to DROP account**
- **No payment option election until actual retirement**
- **DROP balance payable as lump sum or annuitized as additional monthly income**



A Possible DROP for ERS (cont.)

- **Death benefit during DROP participation would be the DROP balance plus any applicable regular active-member death benefit (but using pay and service at DROP entry)**
- **Member can enter DROP upon eligibility for an unreduced retirement benefit**
- **A 5-year maximum for remaining in DROP**
- **Employer contributions continue while in DROP**



A Possible DROP for ERS (cont.)

- **No disability benefit payable if in DROP**
- **No Post Retirement Benefit (PRB) increases applied while in DROP**
 - **But actual monthly income upon actual retirement would be increased for applicable PRB increases that would have been granted based on DROP entry date**
- **This would be close to a top-of-the-line DROP and most likely would add to the System's cost without certain constraints**



ERS Members Who May Be Eligible for DROP

- **Police and Fire members**
- **General employees and teachers grandfathered in the old Contributory Plan and who contribute 7.8% of pay to ERS**
- **General employees and teachers in the Noncontributory Plan**
- **Special employee groups eligible for 25 and out unreduced retirement**



ERS Members Who May Be Eligible for DROP (cont.)

- **A final determination would be made as to which of these groups would actually be included in DROP**
- **Employee groups not eligible for DROP**
 - **judges**
 - **elected officials**
 - **legislative officers**



DROP Benefit Illustrations-Sample Police and Fire Members

<u>Item</u>	<u>P&F #1</u>	<u>P&F #2</u>	<u>P&F #3</u>	<u>P&F #4</u>
Age @ DROP	55	55	55	55
Service @ DROP	25 years	25 years	32 years	32 years
Actual Retirement Age	60	60	60	60
Pay Increase During DROP	0%	8%	0%	8%
Pay at DROP	\$52,000	\$52,000	\$52,000	\$52,000
Final Average Pay at DROP	\$50,000	\$50,000	\$50,000	\$50,000



DROP Benefit Illustrations-Police and Fire

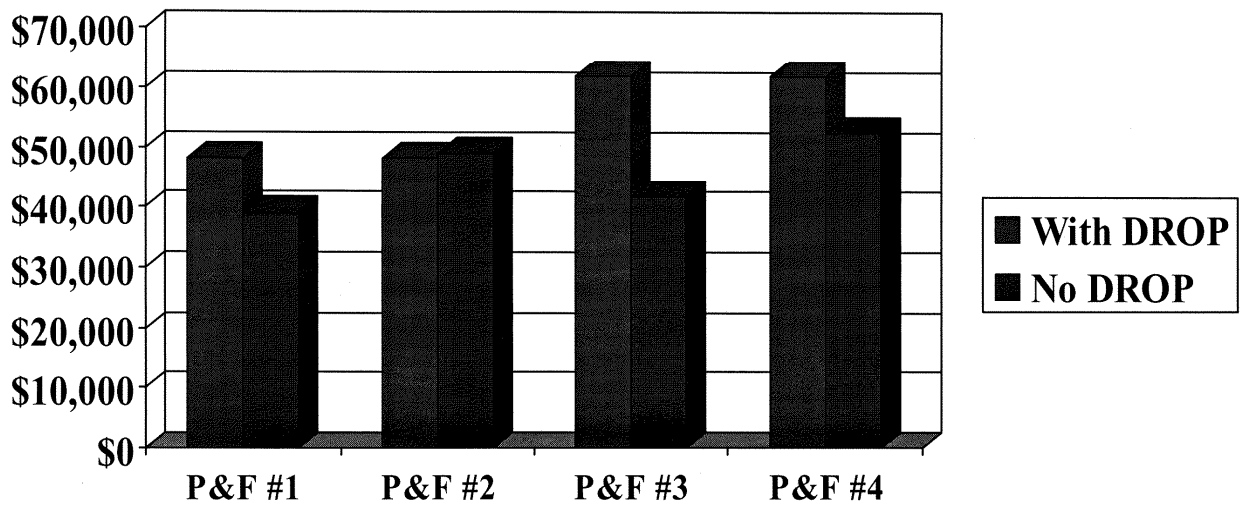
<u>Item</u>	<u>P&F #1</u>	<u>P&F #2</u>	<u>P&F #3</u>	<u>P&F #4</u>
1. DROP Benefit @ Entry	\$31,250	\$31,250	\$40,000	\$40,000
2. DROP Benefit @ Retirement	\$35,156	\$35,156	\$45,000	\$45,000
3. DROP Balance @ Retirement	\$156,250	\$156,250	\$200,000	\$200,000
4. Annuitized DROP Benefit	\$13,265	\$13,265	\$16,980	\$16,980
5. Total DROP (2+4)	\$48,422	\$48,422	\$61,980	\$61,980
6. Formula Benefit if no DROP	\$39,000	\$49,226	\$41,600	\$52,508

Assumes 100% of benefit credited to DROP amount



DROP Benefit Illustrations Police and Fire Members

Total Annual Benefit



DROP Benefit Illustrations-Sample All Other Members

<u>Item</u>	<u>Contrib</u> <u>#1</u>	<u>Contrib</u> <u>#2</u>	<u>NonContrib</u> <u>#1</u>	<u>NonContrib</u> <u>#2</u>
Age @ DROP	55	55	55	55
Service @ DROP	25 years	25 years	30 years	30 years
Actual Retirement Age	60	60	60	60
Pay Increase During DROP	0%	8%	0%	8%
Pay at DROP	\$52,000	\$52,000	\$52,000	\$52,000
Final Average Pay at DROP	\$50,000	\$50,000	\$50,000	\$50,000



DROP Benefit Illustrations-All Other Members

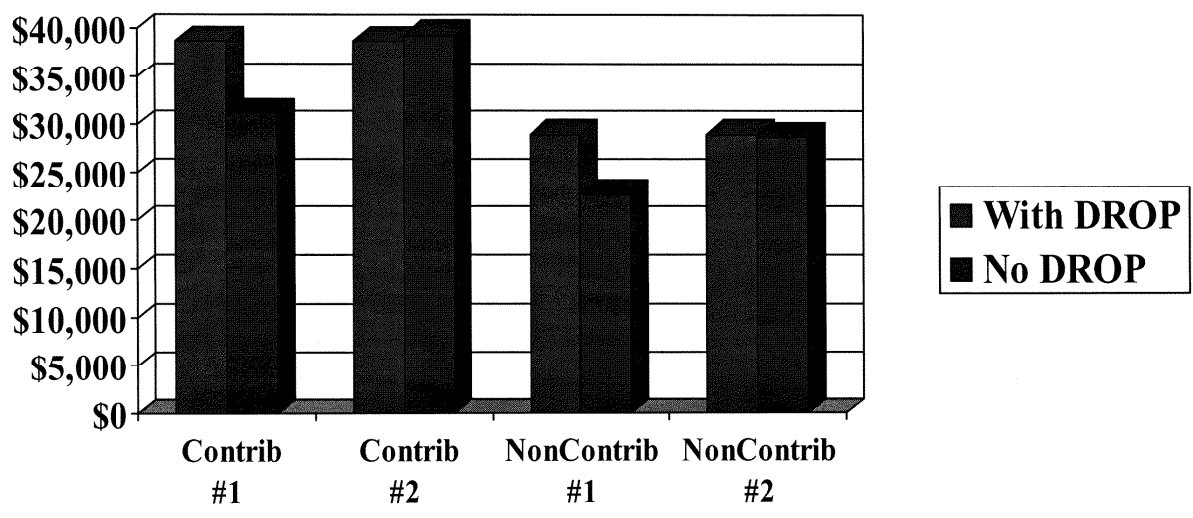
<u>Item</u>	<u>Contrib</u> <u>#1</u>	<u>Contrib</u> <u>#2</u>	<u>NonContrib</u> <u>#1</u>	<u>NonContrib</u> <u>#2</u>
1. DROP Benefit @ Entry	\$25,000	\$25,000	\$18,750	\$18,750
2. DROP Benefit @ Retirement	\$28,125	\$28,125	\$21,094	\$21,094
3. DROP Balance @ Retirement	\$125,000	\$125,000	\$93,750	\$93,750
4. Annuitized DROP Benefit	\$10,612	\$10,612	\$7,959	\$7,959
5. Total DROP (2+4)	\$38,737	\$38,737	\$29,053	\$29,053
6. Formula Benefit if no DROP	\$31,200	\$39,381	\$22,750	\$28,715

Assumes 100% of benefit credited to DROP amount



DROP Benefit Illustrations All Other Members

Total Annual Benefit



Other Alternatives to DROP

Objective	Feature
Delay retirement	Tiered multiplier with higher formulas for additional years of service
Delay retirement	Partial Lump Sum Option not available until 2-3 years after eligibility for unreduced retirement
Introduce defined contribution feature	Cash balance overlay feature
Access to partial lump sum	Partial Lump Sum Option



Special Issues for DROP

- **If retiree is under age 55, the lump sum distribution is subject to 10% penalty tax and 20% withholding if not rolled into an IRA or other plan**
- **Member foregoes future COLAs on portion of benefit taken as lump sum**
- **Increased cash flow requirements for the fund**



Case Studies



Case Study 1: Dallas Police and Fire Pension System

- **Perhaps the ideal environment for a DROP**
- **A verifiable no-cost DROP**
- **Officers were retiring as soon as eligible for unreduced benefit and moving to another city's police or fire department**
 - **They were thus enjoying a significant increase in take-home pay by doing this**
 - **Retirement at 60% of final average pay at age 50 with 20 years of service**



Case Study 1: Dallas Police and Fire Pension System (cont.)

- **Dallas was losing its best and most experience officers**
- **DROP implemented to retain officers**
- **Members' 8.5% contribution ceases, but City's 27.5% contribution continues**
- **Results:**
 - **90%-98% of eligibles participate in DROP**
 - **Verifiable deferral of retirements**
 - **No material increase in actuarial cost, due to their situation**



Case Study 2: Teacher Retirement System of Texas

- **1997 Legislature passed a DROP provision, but required it to be “cost neutral”**
- **Member and State contributions continue during DROP, but only 79% of benefit credited to DROP**
- **Between 1997 & 1999, TRS found that availability of lump sum was main driving force in election decision, not interest in deferring retirement**
- **During 1999 session, a bill was introduced to incorporate a PLSO into TRS benefit options**





Case Study 2: Teacher Retirement System of Texas (cont.)

- **Objectives of PLSO**
 - **Meet members' desire for some lump sum at retirement**
 - **Reduce communication problems**
 - **Have less administrative complexities**
 - **Be truly neutral on actuarial cost**



Case Study 2: Teacher Retirement System of Texas (cont.)

- **TRS PLSO design**
 - **Must be eligible for unreduced retirement**
 - ◆ **Added by Legislature to encourage delaying retirement**
 - **Can elect 12, 24, or 36 months worth of monthly benefit in a lump sum**
 - **Reduced benefit is actuarial equivalent of remaining value of benefit**
- **TRS is getting heavy utilization and option enjoys great popularity**



Two Alternatives for Cost Neutrality

- **The DROP design features were specified by the Legislative Committee**
- **Scope of this project did not include search for more attractive DROP designs**



Alternative #1 for Cost Neutrality

- **A percentage of the DROP benefit is credited to the DROP account**
- **The percentage may vary among the three member groups**
- **Cost neutrality is achieved by affecting the amount of the DROP benefit**



Analysis of Alternative #1

Item	Member Group				DROP for All Groups Total
	Police & Fire	All Other Members		DROP for All Groups Total	
		Drop for Contributory Only	DROP for NonContributory Only		
(1)	(2)	(3)	(4)	(5)	
1. % of Benefit credited to DROP Account	30%	25%	50%	N/A	
2. Employer Normal Cost					
a. Base Line	\$12.3	\$158.5	\$158.5	\$170.9	
b. W/DROP	\$16.3	\$166.6	\$157.1	\$181.7	
3. UAAL					
a. Base Line	\$331.5	\$2,546.6	\$2,546.6	\$2,878.1	
b. w/DROP	\$290.6	\$2,495.2	\$2,571.9	\$2,811.0	
4. Contribution Requirements					
a. Dollar Amt					
i. Base Line	\$44.4	\$400.5	\$400.5	\$444.9	
ii. w/DROP	\$44.8	\$404.8	\$401.4	\$450.7	
b. % of Pay					
i. Base Line	15.33%	14.47%	14.47%	14.55%	
ii. w/DROP	15.47%	14.62%	14.50%	14.74%	
5. Funded Ratio					
a. Base Line	82.5%	74.7%	74.7%	75.9%	
b. w/Drop	84.3%	75.1%	74.5%	76.4%	

Notes: 1. Based on 6-30-2003 Valuation
2. \$ Amounts in \$ millions



Alternative #2 for Cost Neutrality

- **Member must stay in DROP a minimum number of years to get their DROP balance and to have their PRB increases be based on their DROP entry date**
- **If member really retires before completing the specified minimum number of years in DROP, the member will forfeit their DROP balance**
- **If the member really retires before completing the specified minimum number of years, the member's first PRB increase will occur as if the member was never in DROP**
- **The specified minimum number of years could vary among the three member groups**
- **Cost neutrality is achieved by affecting the behavior of the DROP participant**
- **A minimum period of 5 years was used for this study**
- **A maximum DROP period of 10 years was used**



Analysis of Alternative #2

Item	Member Group				Total
	Police & Fire	All Other Members		Total	
		Contributory	NonContributory		
(1)	(2)	(3)	(4)	(5)	
1. Minimum years in DROP	5	5	5	5	
2. Maximum years in DROP	10	10	10	10	
2. Employer Normal Cost					
a. Base Line	\$12.3	\$158.5	\$158.5	\$170.9	
b. w/DROP	\$21.3	\$168.4	\$155.9	\$186.3	
3. UAAL					
a. Base Line	\$331.5	\$2,546.6	\$2,546.6	\$2,878.1	
b. w/DROP	\$278.4	\$2,496.2	\$2,537.5	\$2,765.5	
4. Contribution Requirements					
a. Dollar Amt					
i. Base Line	\$44.4	\$400.5	\$400.5	\$444.9	
ii. w/DROP	\$49.5	\$407.1	\$396.4	\$451.5	
b. % of Pay					
i. Base Line	15.33%	14.47%	14.47%	14.55%	
ii. w/DROP	17.11%	14.71%	14.32%	14.74%	
5. Funded Ratio					
a. Base Line	82.5%	74.7%	74.7%	75.9%	
b. w/DROP	84.9%	75.1%	74.8%	76.6%	

Notes: 1. Based on 6-30-2003 Valuation
 2. \$ Amounts in \$ millions



Closing Comments

- **DROPs have increased in popularity**
- **Originally implemented to encourage retention**
- **Availability of lump sum appears to have become most popular aspect**
- **Only works in members' best interest if elected after eligibility for unreduced retirement and after benefit multiplier has reached its maximum level**
 - **And then only if no significant pay increases**



Closing Comments (cont.)

- **Several state systems have adopted a Partial Lump Sum Option (PLSO)**
 - **Can achieve many of same objectives as DROP**
 - **Member can still get a lump sum**
 - **Member doesn't need to elect until actual retirement, so won't make incorrect choice**
 - **Significantly reduced communication, member relation, and administrative problems**
- **It may be possible to implement a cost-neutral DROP in ERS**
 - **Would vary by member group**
 - **Current design features do not produce attractive results**
 - **Cessation of employee contributions hinders cost neutral design for Police & Fire and Contributory members**



Closing Comments (cont.)

- **Alternative #1 – Credit a % of the Benefit to the DROP account**
 - ◆ **Police & Fire = 30%**
 - ◆ **All Other Contributory = 25%**
 - ◆ **All Other Noncontributory = 50%**
- **Not an attractive design**
- **Police & Fire and Contributory Plans Credit % are small because employee contributions cease during DROP**
- **Noncontributory Plan Credit % is small because of lower multiplier**



Closing Comments (cont.)

- **Alternative #2 – Must stay in DROP a minimum number of years (and maximum of 10)**
 - ◆ **Police & Fire = 5 years**
 - ◆ **All Other Contributory = 5 years**
 - ◆ **All Other Noncontributory = 5 years**
- **Police & Fire is still not actuarially neutral even with 5 year mandatory participation**
 - ◆ **Caused by cessation of employee contributions during DROP**
- **Contributory and Noncontributory Plans combined are close to actuarially neutral**
 - **Noncontributory is slightly subsidizing Contributory if minimum number of years is the same**

