ADVISORY

A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Deferred Retirement Option Plans (DROPs)[1] – (2005) (CORBA)

Background. Over the past ten years, many governments have implemented deferred retirement option plans in order to achieve a variety of financial and human resource management goals.

Although DROP plan features can vary significantly, the plans usually result in a lump-sum payout that supplements an employee's pension. DROP plans allow employees who would otherwise retire in a defined benefit plan to continue working. However, rather than continuing to accrue credit for service and compensation, a certain sum is credited to a separate account under the government's retirement plan. The employee typically receives the money in the account, including an agreed-upon interest amount, in a lump sum when he or she retires.[2]

A significant concern about the use of DROP plans is that costs have been substantially higher than anticipated in some jurisdictions. In these cases, unexpected cost increases have been attributed to factors such as unfavorable plan design and faulty investment return assumptions.

Recommendation. GFOA recommends that governments exercise extreme caution in considering DROP plans and that prior to approving such plans they conduct a structured decision-making process that includes, at minimum, the following steps:

1. Establish an open and credible review process. Because such plans may have far-reaching financial and operational impacts for the government, it is important that prior to implementing DROPs, all relevant factors be thoroughly considered. Further, potential conflicts of interest among decision-makers who design a DROP should be monitored closely. Instances of self-dealing are costly, unethical, potentially illegal, and may harm the long-term credibility of the government entity. Governments considering implementation of DROPS should conduct a review process that
   - is transparent -- that is, that provides for public participation, open discussion and public decision making based on analysis and facts that are made freely available to the public;
   - is comprehensive;
   - identifies and corrects for potential conflicts of interest; and
   - is well documented.

2. Set and communicate explicit goals up front. Establishing and publicly communicating the desired results of a DROP program early in the process will both enhance transparency in the decision-making process and facilitate the establishment of performance measures and subsequent evaluation of results. Inappropriate

[1] This best practice also applies to PLOPs (partial lump-sum options plans), that some governments have implemented in lieu of DROPs.
[2] Definition based on Carol V. Calhoun and Arthur H. Tepfor, "Deferred Retirement Option Plans ("DROP" Plans)." *Pension & Benefits Week*, October 13, 1998.

goals, such as rewarding a select group of staff, should be explicitly rejected. It is critical that goals not conflict with other retirement plan provisions (for example, a government would not want to provide DROPs for retaining employees while also offering early retirement incentives).

Both financial and operational goals should be established. Operational goals typically address human resource needs, as follows:

- Succession planning: DROP plans may make it easier to forecast the level and timing of employee separations from service;
- Employee retention: Some governments have pursued a forward DROP that provides incentives for employees to work for a finite period of time, as a means of retaining employees; and
- Separation from service: Certain governments have established back DROPs that may provide incentives for employees to leave governmental service within a window of time.

Financial goals, because they are based on actuarial and interest earnings assumptions, should be carefully formulated and decision-makers and the public should be fully informed of the inherent risks. For example, even though a plan may be designed to be cost-neutral, a drop in interest rates below the assumed rate may leave the government with a significant unfunded liability. In addition, governments that agree to DROPs or PLOPs in exchange for wage and other operating cost reductions need to include in their risk analysis the prospect that pension improvements tend to be permanent while wages and other operating costs are subject to frequent reconsideration and thus any savings may be reduced or eliminated in future years.

3. <u>Consider and select design options that support financial and operational goals</u>. The following design elements and their implications should be considered:
   - Eligibility parameters. Parameters should be set based on employee retention or separation goals. For example, if a government wants to maximize retention, participation should begin no earlier than normal retirement age.
   - Degree to which decision to participate is binding on employee. An employee's decision to participate may or may not be irrevocable. Irrevocability is desirable because it a) streamlines plan administration, b) avoids possible adverse selection, c) promotes cost neutrality, d) supports succession planning, and d) may avoid creating IRS issues.
   - Length of participation. Participation should be capped, consistent with achieving goals. For example, a government could allow three to five-year participation based on a need to retain employees or induce a reduction in its workforce over a specific time period.
   - Permanency of plan. Governments should consider a sunset provision for DROPs. However, governments should recognize that improvements in pension plans are difficult or impossible to reverse.

4. <u>Analyze cost impact of design options</u>. As stated above in the section on financial goals, governments should recognize and make clear to the public that costs are based on certain assumptions and that actual costs may exceed assumptions. Governments should engage qualified experts to analyze costs and should focus particularly on
   - Investment return assumptions and how they were arrived at. An investment return credited toward the employee account should be conservative and linked to the risk and return of the underlying investments. The government should not guarantee an investment return.
   - Actuarial impact. Governments should retain the services of an actuary to determine if one or more DROP plan scenarios under consideration would be "actuarially neutral." Even if neutrality is not an explicit goal of the DROP, governments should know in advance what the estimated costs are estimated to be, expressed in present value and annualized terms. It may be advantageous to determine if actuarial impacts may vary from one department to another (e.g., the retention effect of a forward DROP may be more pronounced in one department and could influence the scope of the DROP plan roll-out).

5. Conduct a portfolio analysis. Because a DROP plan creates an accelerated need for cash payouts, a government should perform additional portfolio analysis to ensure investments can produce sufficient income to meet liquidity needs.

6. Communicate results of analysis and resulting recommendations widely. Governments should ensure that the results of the review process are communicated to major stakeholders, typically including the following: elected officials, the public, bond rating agencies, the business community, public employee unions, and citizen groups.

References

- Definition based on Carol V. Calhoun and Arthur H. Tepfor, “Deferred Retirement Option Plans ("DROP" Plans),” *Pension & Benefits Week*, October 13, 1998.
- *Benefit Design in Public Employee Retirement Systems*, GFOA
- “Drop Outs,” Christopher Swope, *Governing*, September 2004.

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