STATE OF CALIFORNIA

California Actuarial Advisory Panel

March 11, 2024

SUBJECT: Deferred Retirement Option Plans (DROP): An Actuarial Perspective

Introduction

This letter was written in response to a request from the Legislative Committee of the State Association of County Retirement Systems (SACRS) regarding Deferred Retirement Option Plans (DROPs) under the County Employees' Retirement Law (CERL). SACRS asked the California Actuarial Advisory Panel (CAAP) to provide a response to seven questions related to cost neutrality and other considerations for various types of DROPs as described in Article 11.5 of the CERL.

DROPs offer eligible employees an alternative path to retirement. In a DROP, a member who reaches retirement eligibility can elect to continue working while "freezing" their pension calculation. During participation in a DROP, rather than continuing to accrue increased retirement benefits based on additional years of service and salary adjustments, the employee's monthly retirement allowance is calculated as of their DROP entry date and those payments are deposited into a separate interest-bearing account. Upon the employee's ultimate retirement date, the accumulated value of the DROP account is distributed to them in a lump sum payment.

Additional information on DROPs may be found in a 2003 monograph published by the Society of Actuaries, "Design and Actuarial Aspects of Deferred Retirement Option Programs". A link to that monograph may also be found on the CAAP website at https://www.sco.ca.gov/Actuarial_Products_Guidance.html.

Note currently no California Employers' Retirement Law of 1937 (CERL) plan sponsor has adopted any of the CERL DROP provisions.

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Challenges in Valuing a DROP

DROP plans present multiple challenges for actuarial valuations, including:

- **Behavioral Uncertainty:** It's difficult to predict employee behavior related to DROP. Factors like DROP entry timing, final retirement date, participation rates, and overall career length significantly complicate projections of expected future benefit payments.
- **Anti-selection:** Anti-selection (also referred to as adverse selection) can occur when employees' DROP plan participation decisions are made strategically or with foreknowledge of factors affecting the amount and duration of anticipated benefit payments, such as health status. This can impact actuarial projections and plan costs.

Challenges in Achieving Cost Neutrality

While a determination of "cost-neutrality" is required within the current CERL statutes as a prerequisite to implement a DROP, achieving and preserving cost neutrality poses difficulties. This is primarily because DROPs will tend to preserve the value of early retirement subsidies, especially within public safety groups, that would be lessened if a member had continued working beyond initial retirement eligibility. This can increase costs significantly, depending on the structure of the current benefit formula. Other features of the DROP can also affect whether cost neutrality can be achieved, such as the rate of interest credited to the DROP accounts.

The anti-selection issues will also tend to increase cost, to the extent members can be expected to make decisions that will benefit them financially. Furthermore, the behavioral uncertainty issues identified above make it difficult to determine whether the program is or is expected to be cost neutral.

Response to Questions from the Legislative Committee of the State Association of County Retirement Systems

Question 1: Cost Neutrality in Forward DROPs (GC 31771)

Under what general parameters could the "Forward" DROP provisions under Government Code section 31771 be considered cost neutral?

Achieving cost neutrality with a forward DROP is difficult, especially when early retirement subsidies remain available. Particularly in public safety groups with benefit formulas that are designed to provide significant early retirement subsidies – such as the '3% at 50' formula – allowing the member to set their retirement benefit based on the earliest retirement age can significantly increase the value of the benefit to the member, absent other offsets. For these formulas, the actuarial value of additional benefit amounts that would accrue due to continuation of salary and service increases are generally less than the value that would be obtained by commencing retirement immediately, especially if the benefit includes Cost of Living Adjustments (COLAs). To offset the added costs attributable to preserving these subsidies, adjustments to the benefits earned under DROP will generally be required to achieve cost neutrality, such as:

- Setting the DROP account interest rate below the plan's actual or expected rate of return,
- Permanently waiving or reducing automatic cost-of-living adjustments (COLA) on retirement benefits during the period the member is in DROP, and
- Not crediting the full amount of any contributions made by the member during the DROP period to the member's DROP account.

Question 2: Cost Neutrality in Backward DROPs (GC 31778)
Under what general parameters could the "Backward" DROP provisions under Government Code section 31778 be considered cost neutral?

A backward (or "retroactive") DROP allows a member at retirement to select a past date and then the member's benefit is calculated as though the member had entered DROP upon that date. The member would then receive both the DROP account balance and their monthly retirement allowance, as determined under the parameters of the DROP.

Achieving a cost neutral backward DROP is much harder than for a forward DROP due to the higher anti-selection risk inherent in their retroactive nature, and because of the additional design constraints imposed by Section 31778. Participation in a backward DROP is likely driven by the expected financial advantage reflecting the individual circumstances of the member, greatly increasing the risk of anti-selection issues.

Extremely stringent conditions would be needed for a backward DROP to even approach cost neutrality. This would likely require the cost-offsetting features as described above for forward DROPs, and may necessitate additional offsets to address the additional adverse selection issues. However, the CERL statute as currently written appears to preclude the use of some of these adjustments for a backward DROP, in particular the suspension or reduction of COLAs and partial or non-crediting of member contributions to the DROP account (based on 31778.1(b) and (c)).

Question 3: Cost Neutrality in Actuarial Equivalent DROPs (GC 31777)
Under what general parameters could the "Actuarial Equivalent" DROP provisions under Government Code section 31777 be considered cost neutral?

An actuarial equivalent DROP allows a member at retirement to have a portion of their benefit paid as a lump sum as opposed to an ongoing monthly benefit. Actuarial equivalent DROPs address many of the concerns inherent in forward and backward DROPs. In particular, lump-sum payouts and annuity options should, by design, have equivalent present values under this model and so should be expected to be cost neutral.

The actuarial equivalent DROP avoids the increase in early retirement subsidy issues associated with forward and backward DROPs. Furthermore, building conservatism into the actuarial assumptions used to calculate the lump sum payouts could mitigate possible anti-selection issues associated with an annuity vs. lump sum choice. However, the CAAP makes no representation as to whether the statute currently written allows for such conservatism.

Question 4 – Behavioral changes due to DROP
Under Government Code section 31770.4(c), "the actuarial analysis shall identify all cost elements expected to change due to implementation of the program…such as benefit payments, expected retirement age, and the likelihood of termination or disability by those near retirement age." Based on the experience of other California retirement systems currently or previously offering DROP programs, what behavior changes have been observed by the Panel?

Isolating behavioral changes specifically related to DROP implementation is difficult where DROPs have been in place for a long time and across various retirement tiers. In California, such systems include Los Angeles Fire and Police or the City of Fresno. Further, it's impossible to definitively know when members would have retired absent a DROP option.

The San Francisco City and County Employees Retirement System implemented a DROP effective July 1, 2008 with an automatic "Sunset" as of June 30, 2011. If the program were deemed cost neutral based on a required cost analysis performed every three years, there was an option to renew the program. The definition of "cost neutrality" in the statue also considered human resource implications *outside* of the pension plan, such as recruiting and training costs. The observed behavior was that members entered DROP at rates 50% to 75% higher than the assumed retirement rates. The effect of this behavior was to increase the cost of the System. Even with potential offsetting cost-saving sources for the City, the DROP sunset as of June 30, 2011, and the program was not renewed.

While historical behavioral changes due to DROP are difficult to isolate, some potential behavioral changes in systems with DROPs include:

- Delayed retirement: Members might postpone retirement longer due to the financial advantages offered by a DROP.
- Strategic timing: The decision to enter a DROP and the final retirement date potentially coincide with personal financial goals or market conditions.
- Anti-selection due to health: Individuals with awareness of health conditions might be incentivized to opt into a DROP for greater immediate payouts.

The degree and nature of these behavioral changes will vary depending on specific plan design, actuarial assumptions within the model, and the demographics of the participant population. While DROPs may alter retirement patterns, their overall impact on a plan's health cannot be measured in isolation from other actuarial dynamics and investment performance. Also, to the extent that DROPs do affect behavior, this can affect other human resource considerations *outside* of the pension plan, such as medical benefits or recruiting and training costs.

Question 5 – Source of funding for interest crediting:
Government Code section 31772(c)(4) discusses various interest crediting policies. Based on any other anecdotal information the Panel may have observed, which entity (employer or retirement system) funds the interest credited to a member's DROP account?

The interest credited on DROP accounts is part of the member's benefit. Therefore, like all member benefits the interest credited is funded by employer and member contributions and by actual investment returns. To the extent there are any actuarial losses that occur because the interest credited to the DROP account exceeds the actual earnings on the plan's assets, those losses become part of the plan's overall unfunded actuarial accrued liability (UAAL), which is generally paid by the employer.

Question 6 – Which parties bear risks of significant financial impact:
Which parties (employers, employees, and/or retirement systems) bear the risks should the program result in a significant financial impact?

Any adverse financial impact of a DROP will emerge as actuarial experience losses which increase the UAAL. Because under the CERL the UAAL is generally funded by employer contributions, the risk of any adverse financial impact would typically be borne by the employers, absent changes to DROP benefits to achieve cost neutrality.

Over the long term, negative consequences from a DROP could affect all parties, as any deterioration in the overall financial condition of the system due to DROP may affect benefit and contribution levels.

Question 7: *Please discuss how the IRC 415(b) annual benefit limits are integrated with a DROP lump-sum distribution.*

Benefits paid from a qualified pension plan cannot exceed the IRC 415(b) benefit limit. The 415(b) benefit limit applies to annuity benefits; thus, other forms of benefit payments, such as a lump-sum distribution, need to be converted to an annuity benefit for purposes of 415(b) limit testing. At the member's date of retirement, any DROP lump-sum distribution needs to be converted to an equivalent annuity benefit based on interest rate and mortality assumptions mandated in IRC Section 415(b). The annuitized DROP account balance is then added to the member's annual pension benefit and the sum of the annuity benefits is used to determine if the member's benefits exceed the annual 415(b) limit. Certain plan provisions - such as allowing partial DROP lump-sum distributions or retiree cost-of-living adjustments - may complicate the 415(b) limit calculations and testing.

In order to pay benefits in excess of the 415(b) limits, a System must have a non-qualified or replacement benefit plan. If the System does not currently have this type of plan in place, benefits in excess of the 415(b) limit cannot be paid to the member since PEPRA has eliminated the option to create any new excess benefit plans. The likelihood of a member's benefit exceeding the 415(b) limit would increase if they participate in a DROP, especially if the member has accumulated a large DROP account balance over several years. Potentially, a member may not be able to receive their full benefit with a DROP distribution unless the System already has a non-qualified excess plan.

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As noted above, this document was prepared in response to a request from a public agency, the State Association of County Retirement Systems. The CAAP cannot provide legal advice on the interpretation of the provisions of the CERL that enable the three types of DROPs discussed above. Furthermore, as stated in California Code, Government Code § 7507.2(e): "The opinions of the California Actuarial Advisory Panel are nonbinding and advisory only. The opinions of the panel shall not, in any case, be used as the basis for litigation."

We hope these responses are of assistance.

Sincerely,

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Chair, California Actuarial Advisory Panel

cc: Panel members
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