Deferred Retirement Option Program (DROP)

Employer Explanation

A Deferred Retirement Option Program (DROP) is a payment option that employers may adopt for the MERS Defined Benefit Plan at the division level. Employers may be interested in implementing a DROP as a means to retain experienced staff, as employees electing to participate in a DROP must commit to a future retirement date past their retirement eligibility date.

How Does a DROP Work?

When an employee becomes eligible to retire with unreduced benefit, they may elect to continue working and enter into the DROP for a period of 6–60 months. The duration of the DROP period is an irrevocable decision, and at the end of the period, the employee must retire.

Upon entering the DROP period, the employee is considered to be in retirement payout status. Their FAC will be finalized (including any lump sum payouts and/or other includable compensation) and their monthly retirement benefit will be calculated.

Throughout the DROP period, a portion of the employee's elected monthly pension benefit payment (10%–100% as adopted by the employer) will be allocated to a notional DROP account. The following may also apply, if adopted by the employer:

- An interest rate of 0% or 3% may be applied to the account balance on December 31 of each year.
- An annual cost of living adjustment (COLA) may be applied to the monthly benefit amount.

At the end of the DROP period, the participant's employment will be terminated and they will begin receiving their elected monthly pension benefit. The balance of the notional DROP account will be paid out as a lump sum amount, either directly to the employee as taxable income, or rolled over to a retirement account as directed by the participant or defaulted into a MERS IRA.

DROP does not specifically increase the amount of benefits that could be paid to a participant, but instead offers a participant who is eligible to retire a different payout option for the benefits already earned and calculated.

Employee Benefit Example

Bob has worked and earned service credit for 20 years and is eligible to retire. He decides to participate in the DROP adopted by his employer and makes an irrevocable decision to elect a DROP period of five years. At the time he elected to enter the DROP period, his FAC is determined to be $60,000. The benefit multiplier is 2.0%.

Bob's straight life retirement benefit is calculated as follows:

FAC		Service Credit		Benefit Multiplier		Annual Benefit
$60,000	**X**	**20 years**	**X**	**2.0%**	**=**	**$24,000** ($2,000/mo)

The DROP adopted by Bob's employer credits 100% of the pension benefit to the DROP account and a 3% interest rate. The division does not have a COLA.

Under the terms of this DROP, Bob continues to work for his employer for five more years, but does not earn any additional service credit. Every month during the five years, his monthly pension benefit of $2,000* will be deposited into a DROP account, to which 3.0% interest will be applied annually. At the end of the five-year DROP period, Bob must retire. His DROP account has a balance of $131,241.84, which is available to him immediately. Bob will receive his first monthly pension check the month following his termination of employment.

**The monthly benefit amount allocated to the DROP account is based on the retirement payment option selected when entering the DROP period, the interest rate and pension benefit percentage adopted by the employer. This example assumes Bob selected the Straight Life benefit payment.*

MERS
Municipal Employees' Retirement System

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General Guidelines

Employer Requirements to Adopt the DROP Provision

- Once the employer selects the terms of the DROP provision, including the interest rate (can be 0% or 3%), the pension benefit percentage (10%–100%) and whether a COLA will be applied during the DROP period (if applicable), a certified actuarial valuation will be prepared by MERS (valuation fee assessed) to determine the anticipated impact on the division's Actuarial Accrued Liability.
- If the result of the valuation shows an increase in liability, then the adoption of this provision will require that the division and municipality meet certain funding levels.
- Employers who have been issued a Pension Obligation Bond may be able to adopt this provision if the valuation results support that adoption of the DROP will not increase the division's actuarial accrual liability.

Employee Election of a DROP

- The employee must be eligible to retire with full, unreduced benefits to elect the DROP.
- At election of the program, the employee must choose an irrevocable DROP period of 6–60 months. The DROP period will begin on the first day of the elected month and end on the last day of the terminating month. An employee cannot work past the requested DROP period.
- Service credit will not accrue during the DROP period (cannot be used for MERS to MERS eligibility).
- Employee contributions (if contributory) continue to be withheld throughout the DROP period to help fund the benefit and should be reported as voluntary employer contributions.
- A cost of living adjustment (COLA) may or may not be applied to the DROP payment amount.
- Employees who are retiring from divisions offering both an annuity withdrawal and the DROP may only select one provision at the time of retirement.

Employee Termination

- Upon completion of the DROP period, the employee must be reported to MERS as terminated, so that monthly pension payments may begin. If they wish to continue to work, they will be subject to the retire/rehire rules, including the requirement for a bona fide and 60- day separation from employment.
- The DROP account balance must be paid in a one-time lump sum payment at the time of termination.
- At termination, the participant has up to 60 days to request either a lump sum payment of the account balance or transfer the balance to a qualified retirement plan. In the absence of valid instructions by the participant, MERS will issue the full lump sum into a MERS IRA in their name.
- If the employee chooses to terminate their employment before the end of the DROP period, a 20% penalty will be applied, leaving 80% of the DROP account balance paid out immediately.
- If the employer terminates the employee before the end of the DROP period, no penalty will be applied and the DROP account balance will be paid out immediately.

Death & Disability

- If the employee becomes disabled after electing to participate in the DROP and is approved for a disability retirement, they will receive the full DROP account balance and begin receiving their previously calculated monthly retirement benefit.
- If the employee dies before the end of the DROP period, the benefit will be paid as follows:
    - o The DROP lump sum account will be paid to the DROP account beneficiary. (In the event of the beneficiary's death, the DROP account beneficiary can be changed.)
    - o The monthly retirement benefit will be paid to the monthly pension beneficiary (if applicable) according to the payment option chosen by the employee at the election of the DROP period.

FAQs

- **How will adopting the DROP provision impact the projected liability of our plan?**

  Adopting the DROP provision is likely to result in the active population commencing benefits sooner than they otherwise would, potentially as soon as they are eligible. This generally leads to an increase of the actuarial accrued liability of the plan. Any increase may be partially offset by continued employee contributions (if the division is contributory) during the elected DROP period and/or by investment returns greater than the interest posted on the DROP account, both of which will contribute toward the employer reserve of the plan.

  In addition, employers may elect one or more of the following options to achieve a more cost-neutral result:

  - Apply no interest rate to the DROP amount (options are 0% or 3%).
  - Adopt a pension benefit percentage (to be credited to the DROP account) of less than 100% (options range from 10%–100%, in 10% increments).
  - Opt to not apply a COLA (if applicable) during the DROP period.

  For those groups considering adding a DROP provision, MERS actuaries will prepare a valuation to estimate the impact of the change by using standard assumptions about how the provision will change future retirement behavior and what DROP period eligible participants would elect on average.

- **What actuarial assumptions are used when valuing DROP impact?**

  In addition to the options selected by the employer, the assumption is that all employees will elect the DROP at their earliest unreduced eligibility date and will elect to remain in the DROP for an average of three years.

- **Does a longer DROP period increase liability more than a shorter DROP period, or vice versa?**

  As a general rule, the longer the DROP period, the smaller the liability increase. This is the case when the annual interest credited to the member's DROP account is 3%, whereas the benefits that would otherwise be paid remain in the trust and are assumed to earn interest at a higher rate (equal to the current assumed investment return).

- **Can the DROP be modified under the terms of a collective bargaining agreement?**

  No.

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