DROP Basics: Considerations for Adding a DROP to a Pension Plan

What is a DROP?

A DROP is an option provided to active participants of certain retirement plans. It allows members who elect DROP the option to continue to work beyond their Normal Retirement Date and convert part of their retirement benefit into a lump sum.

DROP Impact – For employers	DROP Impact – For Employees
Encourage employees to work longer especially when it is necessary to keep more experienced employees (e.g., it is difficult to hire experienced law enforcement officers).	Defer pension payments while still working but receive their accumulated benefits as a significant lump sum payout when they retire (end of DROP period).
Typically increases cost of retirement benefits since employees can maximize the value of the retirement benefit since some employees join DROP earlier than they might otherwise retire.	Maximize the value of the retirement benefit by providing the equivalence of their normal retirement benefit benefits for employees who continue to work past their normal retirement dates.
Limits the effect of pay increases on retirement benefits while employees are in DROP.	Give up retirement benefit increases from pay increases and additional service while working during the DROP period.
Assists with succession planning by requiring employees in DROP to identify when they will retire, giving employers ample time to develop a succession/training plan for these employees.	

Do DROPs Increase Pension Cost?

The cost of DROP is often incorrectly identified as the amount of the DROP payments, which grossly overstates the cost of DROP, because employees may have received these benefits anyhow or they forego any increases in their benefits that they would have earned if they continued working without entering the DROP.

However, a DROP can be cost neutral if it does cause members to work longer than they otherwise would have. There are several factors which can make the DROP cost neutral, many of which are difficult to measure. One factor is that the pension plan does not pick up additional pension costs for a new hire to replace an employee who would retire without the DROP. Another factor is that employees in DROP forgo any increases in their pensions due to pay increases and additional service while they are in DROP. There are also other non-pension factors that could reduce the cost of a DROP and are covered below.

What are Non-Pension Considerations?

Adding a DROP often results in employees working longer. Typically, employees delaying retirement affects more than just pension costs, such as:

- Reducing training cost for new employees
- Retaining experienced employees and their hard-earned judgment and expertise
- Reducing promotional opportunities as more senior employees remain in their positions
- Adding to disability costs, as older employees are more likely to become disabled – whether job related or not
- The net impact on health care costs of adding to employee health insurance cost from an older employee group while reducing retiree health care cost because of the deferral of retirement, and
- Higher salaries adding to payroll cost by keeping higher paid employees longer.