Cincinnati Retirement System Deferred Retirement Option Plan (“DROP”)

Several city employees have inquired of the CODE Board about statements that the CRS is losing money on the DROP and a rumor that the DROP plan is going to be discontinued. The notion that the CRS is losing money on the DROP is misinformation, and the rumor that the DROP will be discontinued is false. The DROP cannot be terminated without the agreement of the parties to the Collaborative Settlement Agreement (“CSA”) or approval of the federal court. In other words, neither the City nor its retirement office can unilaterally terminate the DROP.

The DROP was provided for in section 21 of the CSA approved in 2015 by the U.S. District Court for the Southern District of Ohio and incorporated into a 30-year consent decree in the Cincinnati Retirement System litigation. The CSA provided that CRS participants with 30 years of creditable service are entitled to enter the DROP to defer their receipt of retirement benefits for up to five years before retiring. Implementation of the DROP was resisted and delayed by the City and its retirement office, but eventually they complied with the CSA and agreed to terms for the DROP. It was implemented effective January 1, 2017 with a provision for retroactive participation back to January 1, 2016.

With respect to the five-year evaluation of the DROP, the CSA provides as follows:

> The Parties agree to facilitate an independent actuarial analysis of the DROP during the fifth year of its implementation. If, based upon that analysis, the program is not cost-neutral to the CRS Pension Trust Fund, the Parties shall then submit the matter to the Court for possible reformation or closure of the DROP, as warranted by the facts and determined by the Court to assure the DROP is cost neutral, provided that any individual who has entered the DROP shall be entitled to participate in the DROP for five full years.

CODE’s counsel, who is also class counsel for the Current Employees Class under the CSA, is initiating the process for an independent actuarial review of the DROP. Given the cost structure of the DROP, there is no factual basis to contend that it is not cost neutral to the pension trust fund. While an employee participates in the DROP, the City continues to pay a sum equal to 16.25% of the employee’s salary into the CRS pension fund even though the individual’s pension benefit was calculated and “frozen” based on their years of service and final average salary *prior* to entering the DROP. In other words, the CRS receives employer contributions on DROP participants even though they are effectively retired insofar as the CRS pension fund’s liability for their monthly retirement benefits was established when they entered the DROP. In addition to the employer contributions, the CRS receives administrative fees from DROP participants equal to 25% of the employees’ CRS contributions while in the DROP (i.e., 9% of salary). The result is a significant net positive for the CRS.

In addition, while an employee is in DROP, CRS does not pay the employee’s monthly pension benefit to the employee. Rather, the CRS retains the use of such funds during the employee’s DROP participation. And, while the employee is in DROP, the monthly benefit is not subject to

COLA increases. In fact, the employee's pension benefit is subject to a three-year COLA "holiday" *after* the employee exits the DROP. Thus, the overall value of the employee's pension is significantly diminished (and the CRS pension fund's liability is likewise reduced) as a result of DROP participation for two reasons. The pension benefit is based on years of service and final salary at the time the employee enters the DROP as opposed to the date of actual retirement years later and the benefit is stagnant (i.e., it does not receive a COLA increase) for up to nine years from the date of entering the DROP. If the employee retired rather than entering the DROP, the benefit would begin to increase after four years. Over the duration of the participant's receipt of pension benefits, the difference is significant. And if the employee did not enter the DROP or retire, but instead continued working, the value of the pension benefit would increase with each additional year of service and any increases in salary would affect the final average salary calculation. Thus, DROP participation represents a significant savings to the CRS pension fund over the alternatives.

The following illustration (based on actual employee experience) illustrates that the CRS receives a substantial net benefit from DROP participation even when accounting for interest paid on DROP accounts.

> Example employee: 30-year employee with annual salary of $95,000 ($3,653 bi-weekly) assuming annual 2% salary COLA. Monthly pension benefit of $4,900 at 30-year retirement date. Assume full five-year participation in DROP. Assuming interest on DROP account at 2%.[1]

	Salary	Employee Contribution	CRS Fee	Amount Credited to DROP Account	Employer Contribution to CRS	Pension Benefits Credited to DROP	Interest	End of Year DROP Balance	Net Cumulative Benefit to CRS
Year 1	$95,000.00	$8,550.00	$2,137.50	$6,412.50	$15,437.50	$58,800.00	$0.00	$65,212.50	$17,575.00
Year 2	$96,900.00	$8,721.00	$2,180.25	$6,540.75	$15,746.25	$58,800.00	$0.00	$130,553.25	$35,501.50
Year 3	$98,838.00	$8,895.42	$2,223.86	$6,671.57	$16,061.18	$58,800.00	$3,915.32	$199,940.13	$49,871.22
Year 4	$100,814.76	$9,073.33	$2,268.33	$6,805.00	$16,382.40	$58,800.00	$3,998.80	$269,543.93	$64,523.14
Year 5	$102,831.06	$9,254.79	$2,313.70	$6,941.10	$16,710.05	$58,800.00	$5,390.88	$340,675.90	$78,156.01
			$11,123.64		$80,337.37		$13,305.00		

Because this employee participated in the DROP, after five years the CRS has received $78,156 that it would not have received had the employee simply retired even after accounting for the interest paid on the participant's DROP account. The CRS also benefits greatly from DROP participation because the total value of the participant's lifetime pension benefit is significantly reduced by the delay in COLA increases that would have begun after four years had the

[1] Interest credits in the DROP are delayed until after completing two years in the plan. Interest is paid at the rate of the 10-year Treasury Bill, which is 1.56% as of February 19, 2020. An average rate of 2% is used for this illustration.

participant retired until year nine as a result of DROP participation. In the case of the example employee, this results in a reduction in total lifetime pension benefits for a DROP participant of more than $120,000 over 20 years of pension benefits:

	DROP	Regular Retirement
Year 1	$58,800.00	$58,800.00
Year 2	$58,800.00	$58,800.00
Year 3	$58,800.00	$58,800.00
Year 4	$58,800.00	$58,800.00
Year 5	$58,800.00	$60,564.00
Year 6	$58,800.00	$62,328.00
Year 7	$58,800.00	$64,092.00
Year 8	$58,800.00	$65,856.00
Year 9	$58,800.00	$67,620.00
Year 10	$60,564.00	$69,384.00
Year 11	$62,328.00	$71,148.00
Year 12	$64,092.00	$72,912.00
Year 13	$65,856.00	$74,676.00
Year 14	$67,620.00	$76,440.00
Year 15	$69,384.00	$78,204.00
Year 16	$71,148.00	$79,968.00
Year 17	$72,912.00	$81,732.00
Year 18	$74,676.00	$83,496.00
Year 19	$76,440.00	$85,260.00
Year 20	$78,204.00	$87,024.00
Total:	$1,292,424.00	$1,415,904.00
	CRS Savings due to DROP:	$123,480.00

As the illustration also shows, the CRS enjoys continued use of the employee contributions and pension benefits during the five years of DROP participation at no cost to the CRS because the interest payments on DROP accounts are far exceeded by the fees deducted from the employee contributions and the employer contributions, neither of which would be received by the CRS if the employee actually retired rather than enter the DROP. Finally, it should also be noted that DROP participants remain employed by the City and on City health insurance for the five years they are in the DROP; whereas, if they retired, they would be eligible for retiree health care. Thus, DROP participation also reduces the obligations of the 115 Trust Fund for retiree healthcare. In short, the DROP is not merely cost neutral to the CRS, it is highly profitable and beneficial to the CRS.