DATE ISSUED: January 10, 2005 REPORT NO. 05-012

ATTENTION: Honorable Mayor and City Council

SUBJECT: Analysis of the Deferred Retirement Option Plan (DROP)

SUMMARY

THIS IS AN INFORMATION ITEM ONLY. NO ACTION IS REQUIRED ON THE PART OF THE CITY COUNCIL.

OVERVIEW

On October 5, 2004, the City Council requested that the City Manager provide an analysis of the City of San Diego's Deferred Retirement Option Program (DROP). DROP was adopted by the City Council on March 4, 1997 by Ordinance 18385. The program was instituted on a trial basis on April 1, 1997, and was made a permanent benefit on April 1, 2000. In accordance with the San Diego Municipal Code Section 24.1401(b), "DROP is created to add flexibility to the Retirement System and its Members." DROP is also available through San Diego City Employees' Retirement Systems (SDCERS) to Port District and Airport Authority employees. Members must meet the age and service eligibility requirements for retirement to enter DROP. Members that choose to enter DROP have made an irrevocable decision to retire within 5 years.

During that time, the DROP participant continues working for the City, earning a bi-weekly paycheck, and receives most benefits available to active employees, such as the Flexible Benefits Program. However, the DROP participant does not earn additional creditable service, discontinues retirement contributions, and has their retirement benefit calculated at the time of entering DROP. Therefore, should the employee be awarded salary increases or promotions during their participation in DROP, this higher salary does not affect the retirement benefit the participant receives, and because no additional service is credited, the member's retirement benefit is calculated based on the years of creditable service at the time of entering DROP.

While a DROP participant, monthly retirement allowances and cost of living adjustments are paid into a DROP account established for the participant. Other amounts deposited include participant and employer bi-weekly matching contributions of 3.05 percent of his/her current eligible salary, the Retirement System Supplemental Benefit payments (13^{th} check), and interest accrued quarterly at a rate determined by the Retirement Board. The current rate of interest is eight percent, and is credited to the DROP accounts at the same rate as interest is credited to regular employee CERS accounts. The participant may withdraw funds from the DROP account at his/her actual retirement from the City, at which time s/he will also begin to receive regular monthly retirement allowances directly.

During the time an employee is in DROP, the City also ceases payment of the SDCERS employer's contribution and the "pickup" or "offset" made on behalf of the employee. The amount of the employer contribution and employee offset varies depending on the retirement group of the employee. In Fiscal Year 2005, the employer contribution ranges from 14.78 percent for General Fund General Members, to 28 to 30 percent for Safety Members, to 45.41 percent for Elected Officials. The City funds the offset at 5.4 percent for General Classified Members, 7.3 percent for Safety Members and 8.89 percent for Elected Officials. Consequently, City funds save the proportionate employer contribution and employee offset for DROP participants.

Because DROP participants are already fully vested in their retirement benefits, they could leave the City at any time and work somewhere else while collecting a pension from the City. Through the benefits offered by DROP, skilled workers are incentivized to remain in the employ of the City of San Diego, passing along their skills and long-term knowledge to newer workers and future generations. The program provides the City with a relatively predictable timeline with which to perform succession planning and other advance preparation for employee turnover. Through these less tangible benefits, the City of San Diego may realize increased efficiency and effectiveness in the workplace.

San Diego is one of several local jurisdictions and municipalities that employ deferred retirement programs. For example, the Michigan State Police offer a program much like the City of San Diego's, but allows the participant six years in the program, while the County of Arlington, Virginia offers the program for up to three years and the City of Philadelphia offers the program for up to four years. In addition, the City of Philadelphia requires only 10 years of credited pension service, plus meeting the age requirement, to enter DROP. The Florida Retirement System DROP has many of the same requirements as the City of San Diego's, but an effective 6.5 percent annual interest rate is credited on DROP accounts. The City of San Diego's DROP is comparable to that of other public jurisdictions, varying most commonly in the duration of the program and the interest credited by the retirement system on the custodial DROP account.

Other examples of California cities that employ a deferred retirement program are the City of Los Angeles, the City of Fresno and the City of Oakland. In September 2003, SDCERS staff produced a summary of features of DROP plans from nine other public pension systems across the country, attached here as Attachment 1.

DISCUSSION

Since the inception of DROP, a total of 2,226 employees have retired, and 1,539 (69 percent) have participated in DROP. Employee participation in this program has created an estimated total savings of $45.2 million to City funds since the inception of DROP, including an estimated savings of $15.9 million in Fiscal Year 2005.

The average years of service credit for DROP participants is 27.9 years, while the average length of participation in DROP for an individual is 3.5 years. Of these participants, 698 (45 percent) have been Safety Members, while 841 (55 percent) have been General Members. The table below provides a further demographic breakdown of DROP participants since inception.

TABLE 1: DROP Participants since inception

	# of Participants	Percent of Total	Avg. Credited Service Years	Avg. Years in DROP
General - Classified	744	48.34%	28.20	2.7
General – Unclassified	97	6.30%	31.25	2.9
Safety - Police	373	24.24%	26.23	4.4
Safety - Fire	323	20.99%	28.53	4.7
Safety - Lifeguard	2	0.13%	30.53	3.3
TOTAL	1,539	100%	27.90	3.5

Since the inception of DROP, 687 employees have chosen not to participate in DROP, but retired outright. These retirees are even more likely to be General Members, as opposed to Safety, at 74 percent and 26 percent, respectively. The table below provides a further demographic breakdown of Non-DROP participants since inception.

TABLE 2: Non-DROP Participants since inception

	# of Non-Participants	Percent of Total	Avg. Credited Service Years
General - Classified	485	70.60%	22.34
General – Unclassified	20	2.91%	28.08
General – Legislative	1	0.14%	15.11
Safety - Police	131	19.07%	18.69
Safety - Fire	40	5.82%	23.87
Safety - Lifeguard	10	1.46%	14.85
TOTAL	687	100%	21.80

As of November 2004, there are 988 current DROP participants. Of these participants 445 (45 percent) are Safety Members, while 543 (55 percent) are General Members. The table below provides a further demographic breakdown of current DROP participants.

TABLE 3: Current DROP Participants

	# of Participants	Percent of Total	Avg. Credited Service Years

General - Classified	479	48.48%	27.39
General – Unclassified	64	6.48%	31.55
Safety - Police	250	25.30%	25.97
Safety - Fire	193	19.54%	28.33
Safety - Lifeguard	2	0.20%	30.46
TOTAL	988	100%	27.49

As described in SDCERS' Annual Actuarial Valuation of June 30, 2003, the average retirement allowance of a DROP member on that date was $53,899. The average retirement allowance was lowest in the General Retirement Group, at $42,679, while the Safety – Fire Group had the highest average retirement allowance at $66,340.

As a result of these DROP participants, City funds have been positively impacted. City funds have experienced savings due to a reduced employer contribution to the Retirement System. For the average employee, the City pays both an employer contribution and an employee contribution offset. However, for participants in DROP, the offset is eliminated and the employer contribution to the DROP account is limited to 3.05 percent, as described above.

The following examples below show the cost to the City of employing a DROP Participant as compared to a non-DROP Participant in Fiscal Year 2005.

EXAMPLE 1: Police Officer II

	City Wages	City Retirement Contribution and Offset [(1)]	DROP contributions by City	Total City Costs
DROP Participant: Police Officer II	$62,491	$0	$1,906	$64,397
Replacement: Police Officer II	$62,491	$24,284	$0	$86,775

(1) Comprises Employer Contribution and Employee Offset Contribution in accordance with actual rates for Safety Members in Fiscal Year 2005.

EXAMPLE 2: Equipment Mechanic

	City Wages	City Retirement Contribution and Offset [(1)]	DROP contributions by City	Total City Costs

DROP Participant: Equipment Mechanic	$42,808	$0	$1,306	$44,114
Replacement: Equipment Mechanic	$42,808	$9,255	$0	$53,009

(1) Comprises Employer Contribution and Employee Offset Contribution in accordance with actual rates for General Classified Members in Fiscal Year 2005.

EXAMPLE 3: Deputy Director

	City Wages	City Retirement Contribution and Offset (1)	DROP contributions by City	Total City Costs
DROP Participant: Deputy Director	$89,548	$0	$2,731	$92,279
Replacement: Deputy Director	$89,548	$15,062	$0	$106,589

(1) Comprises Employer Contribution and Employee Offset Contribution in accordance with actual rates for General Unclassified Members in Fiscal Year 2005.

Other non-quantified City impacts as a result of DROP include:

- Training costs for a new employee
- Initial higher salary for experienced employees vs. new hires
- Higher productivity for experienced employees vs. new hires

Based on records of total actual participants since inception, the retirement contribution and offset the City would have paid was calculated and compared to the actual DROP contributions the City did make for each employee. Since inception, the City would have contributed $45.2 million more to SDCERS for employer and employee offset contributions, had DROP not been available to employees. In Fiscal Year 2005, a total of $17.9 million would have been contributed by the City for the 988 current DROP employees, had DROP not been available, which is approximately $15.9 million more than the City's required contribution for the actual DROP participants this year. Table 4 illustrates the calculation of the differential costs for Non-DROP participants and DROP participants since inception of DROP and in Fiscal Year 2005 alone.

TABLE 4: City Funds DROP Impact (in millions)

	Fiscal Year 2005 Projected	Year-to-Date DROP (April 1997-Nov 2004)
Total DROP Salaries	$63.9	$278.6

Employer Retirement Contribution Savings	$14.2	$36.4
Employee offset Savings	$3.7	$15.6
Gross Total Contributions Savings	**$17.9**	**$52.0**
DROP contributions made by City	($2.0)	($6.8)
Net Total Contributions Savings	**$15.9**	**$45.2**

CONCLUSION

As shown, the City benefits through DROP, both financially and organizationally. While the benefits of retaining highly trained and skilled workers are not quantified here, it is clear that City funds experience a significant savings in employing personnel for which a full retirement contribution is not required.

Per the Municipal Code, DROP is intended to be a cost neutral program, including the impacts to the City budget as well as the actuarial impacts to the pension system. This report presents an analysis of the impact on City funds only. Because this analysis does not reflect the impact on the Retirement System, the net cost or benefit is not calculated. The Retirement Department is currently working on the impact of DROP on SDCERS and expects to release their analysis in February.

Respectfully submitted,

Lisa Irvine
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APPROVED: P. Lamont Ewell
City Manager

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Attachments:
1. September 10, 2003 Memo to Retirement Board