

The Many Facets of DROPs

February 2, 2026

2:00pm – 2:30pm

NICOLAS LAHAYE, FSA, EA, MAAA, FCA



Agenda

- Basics of a Deferred Retirement Option Plan (DROP)
- Pros and Cons of a DROP
- Other DROP Considerations
- Illustrative Example - DROP

Basics of a DROP

What is a DROP?

- Option often provided by pension plans that allows members to work while receiving pension benefits
- Pension benefits deposited in the DROP (while members continue working for the employer)

Basics of a DROP

What is a DROP (continued)?

- At retirement, members receive their DROP balance (which includes investment earnings)
- Members considered retired (from a pension plan perspective) after entering the DROP
 - Even if the member is still working while in the DROP

Basics of a DROP

What is the purpose of a DROP?

- Allows eligible members to receive a relatively large lump sum upon retirement
- Can be a planning tool for employers to prepare for the eventual retirement of longer service employees

Basics of a DROP

How does the DROP works?

- Member elects to enter the DROP
 - DROP election usually irrevocable
- Member makes his retirement election (including the form of payment) upon entry into the DROP
- Member is still an active employee while in the DROP

Basics of a DROP

How does the DROP works (continued)?

- Member's pension benefits accumulate in a DROP account (while in the DROP)
- Member retires and exits the DROP
- At DROP exit, member receives the DROP balance plus ongoing monthly annuity

Basics of a DROP

Typical consequences of participation in the DROP:

- No additional member contributions
- Pension benefit does not grow after DROP entry
- Mandatory termination of employment

Basics of a DROP

Who is eligible to participate (and for how long)?

- Members that have attained Normal Retirement are usually eligible to participate in the DROP
- Limit on years in the DROP (often up to 8 years)
- Members can leave the DROP before end of DROP period, but not allowed to remain past DROP period
 - DROP balance could be forfeited

Basics of a DROP

Possible DROP balance interest:

- No interest credit
- A constant, fixed rate of interest (4%, 5%,...)
- A variable rate tied to the return of the pension fund
- A variable rate tied to an outside index (like S&P 500)
- Rate of return for participant-directed DROP accounts
- DROP may also charge an administrative fee (like 1%)

Basics of a DROP

How is the DROP balance distributed?

- Lump sum (paying the appropriate taxes)
- Roll DROP balance into an eligible plan or IRA
- Convert DROP balance to a monthly benefit
- Leave the DROP balance in the plan and draw down a portion monthly or less frequently

Basics of a DROP

What is the cost of a DROP?

- Often intended to be cost neutral
- Cost generally comes from:
 - Greater benefits granted
 - For example, investment earnings greater than what the plan earns
 - Changes in participant behavior
 - Change in retirement patterns will have an impact on the cost of the plan

Pros and Cons of a DROP

Pros for Members:

- Accumulated lump sum, building a nest egg
 - Lump sum provides financial flexibility in managing your finances
- Continued income and employment
- May increase the member's overall benefit value, especially if lower salary increases near retirement

Pros and Cons of a DROP

Cons for Members:

- Salary increases during DROP period will not be reflected in the actual benefit at retirement
- Plan benefit increases during DROP period are generally not passed on to DROP participants
- By entering the DROP and receiving a DROP balance, future pension payments are lower

Pros and Cons of a DROP

Pros for Plan Sponsors:

- A way to offer additional benefit choices to members at little or no cost
- Valuable long service employees may be induced to delay their retirement
- Easier to plan for the replacement of long service employees

Pros and Cons of a DROP

Cons for Plan Sponsors:

- Plan administration tends to be more complex and costly
- Difficult to design a truly cost-neutral plan (due in part to anti-selection) that is popular

Other DROP Considerations

- Death or disability during DROP
- Plan improvements and COLAs during DROP
- Accrued sick/vacation leave
- Member/employer contributions
- Health benefits during DROP
- Rehire after DROP

Illustrative Example - DROP

Member Information:

- Currently Age 55
- 20 YOS at age 55, 25 YOS at age 60
- Average Final Compensation:
 - \$120,000 at age 55
 - \$140,000 at age 60
- Member eligible for Normal Retirement (and DROP)
- Member wants to stop working and retire at age 60

Illustrative Example - DROP

Option #1: Member can enter the DROP for 5 years

- Benefit = \$72,000 per year or \$6,000 per month
 - Based on formula of: $3.00\% \times 20 \times \$120,000$
- Monthly benefits deposited in the DROP for 5 years
- DROP balance after 5 years: $\approx \$420,000$ (6% return)
- Member will receive DROP balance and \$6,000 monthly starting at age 60 (after exiting the DROP)

Illustrative Example - DROP

Option #2: Member retires at age 60 (no DROP)

- Benefit = \$105,000 per year or \$8,750 per month
 - Based on formula of: $3.00\% \times 25 \times \$140,000$
- Member to receive \$8,750 monthly starting at age 60

So... Should you Enter the DROP?

- The answer is not simple, many factors to consider
 - Future salary increases
 - Financial readiness
 - Emotional Readiness (ready to stop working by DROP end?)
 - Health
 - Taxes
- Do your homework
 - Talk to others who have been through a DROP
 - Consult with a financial advisor
 - Crunch the numbers for your specific case

In Conclusion

- DROPs are popular, but not always well understood
- Choosing to enter (or not enter) the DROP has real life and financial consequences
- Important for members to fully understand the provisions of their DROP before making a decision
 - Remember: DROP election usually irrevocable

Questions?