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House Bill 1281

Actuarial Cost Study prepared for
Joint Committee on Public Retirement and Social Security Programs
of the Arkansas 93rd General Assembly

Provisions of the Bill

House Bill 1281 affects the Arkansas Public Employees Retirement System (APERS). Currently, APERS has a Deferred Retirement Option Plan (DROP). If a person elects to go on DROP their benefit stops accruing at that time. That is, pay raises and service after the person goes on DROP, do not add to their retirement benefit. As the member continues to work, 75% of their frozen retirement benefit (63% at 28 years of service, 69% at 29 years of service) goes into their DROP account. When the person eventually retires, they receive the balance of the DROP account usually paid as a lump sum. Also, 100% of their frozen monthly benefit with COLAs begins. A person can stay on DROP for up to 7 years.

House Bill 1281 would extend the maximum period of time on DROP from 7 years to 10 years

Fiscal Impact

This bill will cause some people to stay on DROP longer (a slight cost savings), and cause some to go on DROP earlier (a cost increase). The actual cost would depend upon what choices the members make. We reviewed the potential impact of this bill under various scenarios. Our projections indicate that House Bill 1281 does not significantly impact the unfunded liability or contribution rate of APERS. But employers will have to pay the current contribution rate of 15.32% of payroll for a longer period. We estimate that employers will pay an additional $700,000 per year in contributions (see Additional Assumptions).

Policy Issues

Here are some policy issues that the Committee may want to consider:

1. The Arkansas Teachers Retirement System has a 10-year DROP. But in a recent review of systems across the country, it was concluded that a 10 year DROP period is rare. That review indicated that the typical DROP period was 5 years. In recent years, one Texas system that had a ten year DROP eliminated the DROP program and the Houston public safety systems have had significant public scrutiny.
2. The current design of the DROP in APERS creates a “trade off” of a lump sum (DROP balance) for monthly retirement benefit. A person who goes on DROP for 7 years has “traded” about 25% of their expected monthly benefit for a lump sum. If the period were

increased to 10 years, they will be able to "trade" a little over 35% of their monthly benefit. The ability to "trade" about 35% of the expected monthly benefit for a lump sum may conflict with the objective of providing a guaranteed retirement income.

3. The longer DROP period could have public perception problems. The DROP accounts can become a significant dollar amount. For example, a typical member on DROP for 7 years has a lump sum that is about 3 times their final salary. If the DROP period was extended to 10 years, that lump sum amount would become over 4 times the final salary.
4. The IRS limits the dollar amount of benefits that can be paid by a retirement system. These limits are usually referred to as "Section 415 limits". APERS members who have a salary of $120,000 or more may have either their benefit or DROP account limited because of the Section 415 limits, if the period is increased to 10 years.

Additional Assumptions

We have used the method and assumptions for DROP that are part of the system's valuation. This includes an assumption for when members leave employment and then infers how many of them take DROP based on what would have been the best economic decision for that person. We have made the additional assumption that members on DROP will stay an additional year due to House Bill 1281. There is an employer contribution difference for that additional year between the salary of the member on DROP and a new member salary.

Sincerely,

Jody Carreiro, EA, ASA, MAAA, FCA
Actuary