Return of the *BAC-DROP*

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An increasingly popular option within retirement plans for sworn employees is BAC-DROP (Benefit Actuarially Calculated DROP). As attractive as forward DROP is for both employees and employers, it is not without its limitations. So as an alternative, actuaries created BAC-DROP, a less complicated off-shoot of traditional DROP, with a lump-sum payout.

BAC-DROP - Benefit Actuarially Calculated DROP- a provision in public sector plans which allows an employee to have lifetime monthly benefits actuarially reduced, along with an immediate reduction in creditable service, in exchange for a one-time, lump sum payment; also known as Reverse DROP.

With BAC-DROP, the employee can effectively delay entering DROP until the actual date of retirement. The pension is modified retroactively as if the employee had elected DROP in prior years. In this way, the employee receives an immediate lump-sum, without an employment commitment. It's an arrangement that allows the employee to turn the clock back, typically up to five years.

Sample BAC-DROP:

Fire Chief Smith has 30 years of service with City X and a final average salary (FAS) of $100,000. The terms of the plan allow him to retire with an annual pension of $88,500. Rather than collecting his full pension, he decides to BAC-DROP 4 years and receive a reduced pension. His years of service are consequently lowered to 26 years and his final average salary adjusted as well (also typically lower). His new pension is calculated as if he had entered the DROP 4 years ago. Let's assume his newly calculated FAS is $91,000. This yields a pension of $71,000 and an immediate lump sum DROP payment of $284,000 (not accounting for earnings/interest, or COLA).

Most BAC-DROP arrangements reimburse the employee for the pension contributions made in the years "BAC-DROP'd". This policy is consistent with forward-DROP. So in the previous example, say Chief Smith had been putting 10% of his annual salary each year toward the pension plan. Over a 4-year BAC-DROP period, his pension office calculates his contributions were $38,000. This amount will be distributed to him (along with a nominal interest payment typically) as a direct taxable distribution, or as a rollover to an IRA or other qualified plan.

BAC-DROP Advantages

From an employee's perspective, the most attractive feature of BAC-DROP is its immediacy. Once reaching normal retirement age, an employee is eligible to BAC-DROP and separate from service immediately. Unlike forward-DROP which has the uncertainty of a future time commitment of employment, BAC-DROP arrangements remove uncertainty over the future. An employee can effectively customize his pension by choosing an exact number of years to calculate a DROP payment and pension. Additionally, interest rates used to calculate lump sums from BAC-DROP tend to necessarily be fixed since the employee has the benefit of hindsight. In this way, the employee doesn't have the uncertainty or risk of a self-directed investment plan, or of a floating interest rate. Similarly, disability insurance is a moot point under BAC-DROP insofar as workplace coverage, since the employee separates as soon as administratively possible.

Whereas forward-DROP requires an employment commitment, BAC-DROP requires none. It is this fundamental feature of BAC-DROP that is not so attractive to employers. Surprise retirements are common and this leads to challenges in terms of orderly recruiting and hiring. Whereas forward-DROP lends itself to orderly retirement transitions, BAC-DROP lends itself to disorderly surprises. Although an employee in forward-DROP can retire at any point, the ever- increasing DROP payment at the "end of the rainbow" acts as a powerful incentive for the employee to remain on payroll.

Whether to elect forward-DROP or BAC-DROP

For those jurisdictions that offer employees both forward-DROP and BAC-DROP at normal retirement age, additional financial planning aspects need to be considered, including:

- The employee's willingness to continue working- the stress and nature of the job may be overriding factors for an employee not to commit to a forward-DROP.
- The employee's risk tolerance and financial assets- all things being equal, the greater an individual's investable assets, the more flexibility they have in accepting a lower pension under BAC-DROP. This is particularly true if they also have a sound balance sheet, with minimal debt. Conversely, someone with inadequate savings and a higher appetite for risk would favor a forward-DROP, preserving their full pension, while accumulating money in DROP.
- The employee's relationship status (single vs. married)- a single person may be more inclined to take risk by electing a more aggressive payout option, since joint payout options would be unavailable. Consequently, the trade-off in electing forward-DROP may be acceptable given a higher risk preference.
- The employee's feelings about the future: economy, personal circumstances, etc.- this factor is particularly important if the employee's choices for the investments are either self-directed or pension-based, rather than a fixed interest rate.

As a final point, it is important for an employee considering BAC-DROP to confirm with the pension office the benefit levels in place for their particular BAC-DROP date. Perhaps the current multiplier is greater than the one used in previous years. There are a lot of moving parts when it comes to both kinds of DROP and making a mistake can be costly. All of the different rules present potential pitfalls, so leveraging a financial professional who specializes in DROP is essential. With proper planning, exiting from DROP should be a smooth process. Consider contacting us to discuss your specific situation so we can design a comprehensive, customized plan for you and your family.

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