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VIA EMAIL & USPS

October 4, 2018

Mr. Raymond P. Ciranna  
General Manager  
City of Los Angeles Fire and Police Pension Plan  
701 East 3<sup>rd</sup> Street, Suite 200  
Los Angeles, CA 90013

**Re: Los Angeles Department of Fire and Police Pensions (LAFPP)  
Deferred Retirement Option Plan (DROP) Proposed Modification Cost Study**

Dear Ray:

As requested by the City in their June 27, 2018 letter and as directed by your office, we have analyzed the cost impact to the City<sup>1</sup> of two proposed modifications to the current DROP program. The calculations included in this study are based on membership and financial information used in preparing the most recent actuarial valuations for LAFPP as of June 30, 2017. The results in this study have been prepared to allow the City and the bargaining groups to evaluate the potential change in the City's future annual cost to provide DROP benefits within the retirement and the retiree health plans<sup>2</sup>.

## RESULTS

For the purpose of this study, we estimated that the two proposed modifications to the DROP program, if applied to all employees who are anticipated to sign up in the future for the DROP, would result in aggregate cost savings to the City of approximately 0.87% of payroll (or \$12.8 million in the first year)<sup>3</sup> for the pension plan and health plan combined assuming contributions are made at the beginning of the year. In the later part of this letter, we have provided our assumptions and methodology as well as more detailed results relating to the estimated cost savings.

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<sup>1</sup> The cost impact is for the City, Harbor Port Police and Airport Police combined.

<sup>2</sup> We have included an analysis for the cost of the retiree health plan because under one of the modifications considered by the City, an employee who signs up in the future for the DROP would be allowed (subject to certain conditions) to stay in active employment beyond five years of participation in the DROP. Under that scenario, there could be a savings to the cost to provide retiree health benefits.

<sup>3</sup> The annual savings have been estimated based on a total active member projected payroll (including members who are currently participating in the DROP) of \$1,475.5 million for 2017/2018.

For the purpose of the ongoing valuations, we recommend that only the projected cost savings associated with the suspension of DROP payments be reflected (i.e., 0.46% of payroll or \$6.8 million in the first year). We recommend that the projected cost savings associated with members potentially delaying their retirement to make up for the suspension of DROP payments be reflected in the valuations only after actual experience becomes available.

## **BACKGROUND AND PROPOSED MODIFICATIONS TO DROP**

In 2001, voters approved a Los Angeles City Charter amendment to allow members in LAFPP to participate in a DROP program. Beginning in May 2002, eligible members could participate in DROP for a period of up to five years. The members must then retire from the City upon exiting the DROP.

Upon electing DROP, an active member's pension benefit would be frozen (except for an annual cost-of-living adjustment similar to that payable to retirees) and the pension benefit would be credited on a monthly basis into a bookkeeping account maintained for that active member. The bookkeeping account would be credited with interest at 5% per year and the final balance is available in a lump sum and payable to the member in addition to the pension benefit at the time of exit from the DROP and retirement from the City.

The City has proposed the following two modifications to the DROP program for active members who have not signed up for the DROP:

- 1) Effective January 1, 2019, any new DROP entrant will be required to be on active duty status for a minimum of 112 hours in a calendar month in order to be credited with the monthly DROP payment for that particular calendar month. However, any sworn employee participating in DROP who sustains a serious injury on duty and is admitted to a hospital for a minimum of three days as a direct result of the on-duty injury will be exempt from the suspension of DROP payments for a period not to exceed 12 months. The payroll codes that qualify for "active duty status" were provided to us by the City and are attached in Exhibit 1.
- 2) For those members in 1) whose DROP payments are suspended due to not satisfying the minimum 112 hours on active duty status, the maximum DROP participation period of five years will be extended by the number of months that DROP payments are suspended, to a maximum of 30 additional months. However, the crediting of interest on the DROP account balance will not extend beyond the original five-year period.

## **ASSUMPTIONS REQUIRED FOR COST STUDY**

In order to evaluate the cost impact, we needed to make assumptions on the following:

- Assumption #1 - The number of months DROP members would have their DROP payment suspended during their DROP participation period; and

- Assumption #2 - The number of months those DROP members would elect to extend their participation period in DROP after their DROP payments suspension.

Assumption #1 - Number of Months of Suspension During DROP

To develop this assumption, we looked at the experience of the 1,303 current DROP participants as of June 30, 2017. LAFPP provided us with a data file, which included for each of the 1,303 DROP participants the total number of months the member has been enrolled in the DROP program as well as the total number of months that DROP payment would have been suspended had the proposed change 1) discussed above been in effect. However, the total number of months of suspension might be overstated, as there is no information available from LAFPP indicating whether any of the affected DROP members had sustained a serious injury on duty and therefore would be exempt from the suspension of DROP payments for a period not to exceed 12 months.

In the following table we summarize the data based on whether the DROP members have had zero months, exactly one month, or more than one month of payment suspension:

<b>1,303 Current DROP Participants as of June 30, 2017</b>				
(1) Number of Months with DROP Deposit Suspended	(2) Percentage of DROP Participant in Each Category	(3) Avg. Number of Months of Suspension	(4) Avg. Number of Months in DROP	(5) Avg. Number of Months of Suspension Extrapolated for the Full 5 Years of DROP Participation (3) x 60 / (4)
0 Months	58%	0.0*	22.0*	1.1
1 Month	12%	1.0	33.3	1.8
More than 1 Month	30%	7.0	34.9	12.1
All Categories Combined	100%		27.2	4.5

\* We observed that DROP members with 0 months of suspension also have a relatively shorter period of DROP participation (22 months on average). Part of the reason that this group has 0 months of suspension may be because they have only been in the DROP for 22 months and a suspension may occur in the later part of their DROP participation period. Therefore, we used the average number of months of suspension for all other DROP members who had no suspension during their first two years of DROP (these DROP members have 0.6 months of suspension over 31.3 months of DROP participation) to extrapolate the expected number of months of suspension for this group of members to arrive at 1.1 months (i.e.,  $0.6 * 60 / 31.3$ ).

The 1,303 current DROP participants have, on average, been in the DROP for about 27 months. We extrapolated the average number of months of suspension if the DROP members would participate for the full 5-year DROP period to be about 4.5 months<sup>4</sup>.

<sup>4</sup> The suspension assumption of 4.5 months has been applied on the average to determine how much the current non-DROP members as a group would be ineligible for DROP payments under the proposed modification. However, in practice, the suspension for an individual member would be determined on a full month basis for each calendar month.

We also summarized below the average number of months of suspension for each full year that the 1,303 DROP members are enrolled in DROP<sup>5</sup>. This shows that DROP suspensions occurred somewhat uniformly over the member’s DROP participation period.

<b>Number of DROP Deposits and Suspension for Each Full Year of DROP Enrollment for the 1,303 Current DROP Participants as of June 30, 2017</b>					
		(1)	(2)	(3)	(4)
		First Full Year of DROP Participation	Second Full Year of DROP Participation	Third Full Year of DROP Participation	Fourth Full Year of DROP Participation
(a)	Number of Months with DROP Deposit	11.3	11.1	10.9	10.6
(b)	Number of Months with DROP Suspended	0.7	0.9	1.1	1.4
(c)	Number of Months Enrolled in DROP	12.0	12.0	12.0	12.0
(d)	Percentage of DROP Deposit (a) / (c)	94%	92%	91%	88%

Based on the above analyses, we assumed that the future DROP participant, on average, would have 4.5 months of suspension of DROP deposit during their 5 years of participation in the DROP and that the 4.5 months of suspension would happen uniformly throughout the 5-year DROP period<sup>6</sup>.

Assumption #2 - Extend DROP participation period by the number of months of DROP Suspension

There is no actual data available to set the assumption on whether the above DROP participants would elect to extend their period in DROP by the full 4.5 months or some fraction thereof, to make up for the reduction in the DROP account as a result of the suspension. For purposes of determining the cost impact in this study, we assumed that the DROP participants would extend their DROP participation period by the full 4.5 months that their DROP payments are assumed to be suspended.

Other Assumptions

These DROP modifications only affect current active (non-DROP) members. Therefore, we determined the cost impact of the DROP modification for only the 12,024 active members who

<sup>5</sup> For example, for a member with 42 months of DROP participation as of June 30, 2017, his/her participation is counted in only the first three columns (first full year, second full year and third full year of DROP participation) but not in the fourth column (fourth full year of DROP participation) as he/she has not participated a full fourth year (or full 48 months) in DROP.

<sup>6</sup> Since members would be expected by our assumption to stay in DROP for 5 years, excluding 4.5 months of DROP payments would have the effect of decreasing the DROP account balance by about 7.5%.



were included in the June 30, 2017 valuations who had never elected DROP as of that date. All assumptions used in this study, except otherwise stated in this letter, are the same as those outlined in our June 30, 2017 funding valuations. The aggregate cost impact expressed as a percentage of payroll is determined based on the total payroll (non-DROP and DROP payroll), similar to how contribution rates are determined in the valuations and paid by the City for all DROP and non-DROP active members.

**IMPACT ON CITY OF PROPOSED DROP MODIFICATIONS**

*Suspension of DROP payment if not satisfying the minimum 112 hours of active duty status*

Assuming the current active members would have 4.5 months of suspension in their DROP deposit after they sign up for the DROP, the aggregate cost savings for the City is 0.46% of payroll (or \$6.8 million in the first year)<sup>7</sup> for the Pension Plan as a whole. Note that there is no cost savings to the Health Plan for this DROP modification as we continue to assume that the future DROP members will commence their retiree health benefits after their 5 years of DROP participation. The detailed cost savings are as follows.

<b>Cost Savings for the City of 4.5 Months of Suspension of DROP Payments*</b>			
	Pension Plan	Health Plan	Total
Normal Cost %	0.18%	N/A	0.18%
UAAL %**	0.28%	N/A	0.28%
Total Saving %	0.46%	N/A	0.46%

- \* The cost saving percentage is calculated based on the total payroll (non-DROP and DROP payroll), assuming contributions are made at the beginning of the year.
- \*\* The reduction in the UAAL is \$48.7 million for the Pension Plan.

It should be noted that if future DROP members were to increase the number of hours worked in order to meet the minimum 112 hours requirement to stay on active duty, the cost savings would be reduced. In that circumstance, the cost savings can be prorated based on the actual experience<sup>8</sup>.

*Extend the DROP participation period by the number of months of suspension*

As we mentioned earlier, there is no data to determine whether future DROP members would extend their DROP participation beyond the current 5-year DROP participation period. If we assume that the DROP participants extend their DROP participation period by the same 4.5 months that their DROP payments are suspended, the additional cost savings for the City of the DROP participation extension is 0.41% of payroll (or \$6.0 million) for the Pension Plan and

<sup>7</sup> This has been estimated based on a projected payroll of \$1,475.5 million for 2017/2018, assuming contributions are made at the beginning of the year.

<sup>8</sup> For example, if members are expected to have on average half or 2.25 months of suspension instead of 4.5 months, the aggregate cost savings would be:  $0.46\% / 4.5 * 2.25 = 0.23\%$ .

Health Plan combined. There are associated cost savings to the Health Plan because the 4.5 months extension of DROP participation means that the future DROP members will commence their retiree health benefit 4.5 months later than our current assumption. The detailed cost savings are summarized below.

<b>Additional Cost Savings for the City of Extension of DROP Participation by 4.5 Months</b>			
	Pension Plan	Health Plan	Total
Normal Cost %	0.12%	0.04%	0.16%
UAAL %**	0.19%	0.06%	0.25%
Total Saving %	0.31%	0.10%	0.41%

\* The cost saving percentage is calculated based on the total payroll (non-DROP and DROP payroll), assuming contributions are made at the beginning of the year.

\*\* The reduction in the UAAL is \$32.4 million and \$10.9 million for the Pension Plan and Health Plan, respectively.

Similar to the above, to the extent that future DROP members do not extend their DROP participation by the full 4.5 months, the cost savings can be reduced proportionately.

For the purpose of this study, we estimated that the two proposed modifications to the DROP program would result in aggregate cost savings to the City of approximately 0.87% of payroll (or \$12.8 million in the first year) for the pension plan and health plan combined assuming contributions are made at the beginning of the year.

For the purpose of the ongoing valuations, we recommend that only the projected cost savings associated with the suspension of DROP payments of approximately 0.46% of payroll (or \$6.8 million in the first year) be reflected. We recommend that the projected cost savings associated with members potentially delaying their retirement to make up for the suspension of DROP payments be reflected in the valuations only after actual experience becomes available.

In addition to waiting until actual experience is available, our recommendation to defer reflecting the potential cost savings of delaying retirement is based on the consideration that the process required to estimate the impact of a non-integral year of delay in retirement (in this case the 4.5 months as stated in Assumption #2) is more complicated than our current valuation process which uses rounded number of years of participation in the DROP.

**ADDITIONAL CONSIDERATIONS**

- We assume that there would be no vested right issues associated with applying the above modifications to reduce a member’s benefit.
- The cost savings provided herein is expressed for the Plan as a whole. The cost savings for each tier and by employer (i.e., the City, Harbor Port Police and Airport Police) would vary based on the number and demographics of active non-DROP members

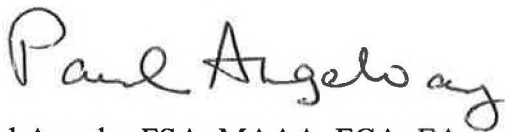
enrolled in those tiers by each employer. We would provide the tier-by-tier employer rates upon further request after the proposed modification is finalized and approved.

- The cost savings determined in this letter is for the Pension Plan and the Health Plan. We have not analyzed any possible impact of the DROP modifications on any other non-pension and non-retiree health benefits or other costs to the employers. These additional cost considerations may include any impact on the City's payroll or the impact on the City's active employee health program if the DROP members extend their DROP participation beyond the original 5-year period. They may also include any impact on the City's Workers Compensation program, disability benefits offered through LAFPP, and/or the cost of administering the DROP.
- Some active employees might accelerate their decision to sign up for the DROP before the effective date of the change of January 1, 2019. If that were to happen, not only would the savings described in this study be reduced, there could be some actuarial losses in particular if those employees sign up for the DROP earlier than expected by the retirement rates assumed in the valuations. We have not included any analysis of this potential experience loss.

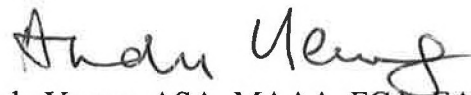
We are members of the American Academy of Actuaries and we meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion herein.

We look forward to discussing this report with you.

Sincerely,



Paul Angelo, FSA, MAAA, FCA, EA  
Senior Vice President and Actuary



Andy Yeung, ASA, MAAA, FCA, EA  
Vice President and Actuary

EK/gxk

cc: Robyn Wilder  
Joseph Salazar

# Exhibit 1

## Payroll Codes that Qualify for “Active Duty Status”

<b>Payroll Code</b>	<b>Description</b>
HO	Holiday Hours
HW	Actual Hours Worked
JD	Jury Duty
KS	Old Overtime Off at Straight Time (Police)
KT	Old Overtime Off at Time and One Half (Police)
LD	Light Duty Return to Work Program
LP	Leave with Pay
ML	Military Leave Without Pay
MP	Military Leave With Pay
PM	Preventive Medicine
TO	Overtime Taken Off (1.5)
TS	Overtime Taken Off (Straight)
VC	Vacation
VF	Platoon Duty Vacation
VS	Special Duty Vacation