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# Connecticut Regional Institute for the 21<sup>st</sup> Century

Comparing Connecticut with Other States on the Handling of the  
Public Employee Plan Funding Crisis

December, 2010

*Final Report*

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**CT21**

CONNECTICUT REGIONAL INSTITUTE FOR THE 21<sup>ST</sup> CENTURY

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# Background

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- The Connecticut Regional Institute for the 21<sup>st</sup> Century (CRI) has conducted research on a number of important state public policy issues and published results to provide information and recommendations that generate discussion and action that enhance the state's overall competitiveness.
- CRI retained Blum Shapiro to report on what states are doing across the country to handle the funding crisis for retirement and post-retirement benefits in public plans and to present ideas on how the State of Connecticut could benefit from some of the strategies (actions) taken by other states to address funding challenges. As agreed upon with CRI, Blum Shapiro has partnered with Hooker and Holcombe and following the approach described on the next page, we are pleased to provide this report as a result of our work.

# Approach

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- Blum Shapiro and Hooker and Holcombe have performed extensive research of existing studies performed on all 50 states' pension and retirement benefit plans. This research was used to develop findings and recommendations that could be used to potentially modify Connecticut's approach to pension and retirement benefit plans that would be in line with what other states are doing.

# Introduction

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- There are 5 sections contained in this report
  1. What Other States are Doing to Address Funding Shortfalls
  2. Connecticut's Pension Tiers
  3. Considerations for a Defined Contribution Plan
  4. Retiree Medical
  5. Policy Considerations that Connecticut Must Answer

# Overview of Connecticut's Plans

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- The State of Connecticut provides a defined benefit pension plan and a retiree health plan for its employees as collectively bargained for by the Connecticut State Employees Retirement System (SERS).
- In addition, state employees participate in Social Security for which the state contributes 7.65% of an employee's compensation (6.2% for OASDI and 1.45% for Medicare).
- The State of Connecticut also provides teachers with a defined benefit plan (Connecticut Teachers' Retirement System); however, members do not participate in Social Security or Medicare. The Teacher's Plan is funded by local boards of education.
- A defined benefit pension plan is a retirement program that provides a monthly benefit to its participants at retirement. In addition, the plan may provide its participants death benefits and disability benefits.
- Benefits are generally related to the amount of time a member participates in the plan (i.e., years of service) and the member's compensation. With additional service and progressively higher compensation, a participant's pension benefits will increase over time. Social Security benefits will also increase with time in the system.
- Although the state's retirement eligibility rules do not match up exactly with Social Security, it is expected that the combination of the two programs will provide an adequate benefit to a retired career employee.

# What Other States are Doing to Address Funding Shortfalls

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- Since the 2008 financial meltdown, the tension between the fiscal health of the states' retirement programs and the need for states to provide other services has been especially intense. This section looks at the type of actions that states have taken to control their retirement plan costs.
- Because of the wide variation and the uniqueness of each state's circumstances, we focused on the type of action rather than the specifics, thus if a given state increased employee contributions to help fund the pension plan, we recorded the action as "employee contributions." We did not record the size or the specifics of the increase.
- In some cases states took the same type of action in different years. For instance, Hawaii changed its re-employment rules for retired employees in 2008, requiring a one-year waiting period, among other requirements. In 2010, it changes its re-employment rules again by requiring retired employees to re-enroll into the retirement system and make employee contributions. Because the state could have made the same changes in a single year, the two changes were counted as a single action to change the plan's re-employment rules.

# What Other States are Doing to Address Funding Shortfalls

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In determining a state action, the following categories were established:

- Eligibility:** A change to participation in the plan. For example, an increase in the minimum compensation or hours to be a participant.
- Compensation:** A change in the definition of compensation, such as a cap on compensation increases between plan years, or an increase in the averaging period.
- Benefits Cap:** A change in the maximum benefit the plan will pay as a fixed dollar or fixed percent of pay.
- Multiplier:** A change in the percent per year of compensation that is used to calculate the final benefit.
- Service:** A change to the definition of service or the inclusion of a service gap.
- Vesting:** Any change to the minimum service required to be considered for benefits. For example, an increase from five years of service to ten years in order to receive state funded benefits.
- Early Retirement:** A change in the definition, minimum requirements, or the benefit reduction factors.
- Normal Retirement:** A change in the definition of minimum requirements.
- Cost of Living Adjustments:** Any change to the annual benefit increase to which a retiree is entitled.
- Pension Obligation Bond:** The issuance of a bond to fund the retirement plan.
- Employer Funding:** Any legislative-driven change to the funding of the retirement plan.
- Employee Contributions:** Any change to the amount employees must contribute as a condition of participation.
- Retirement Incentive Program:** Any program to reduce the state employee workforce by encouraging retirement or early retirement.
- Re-employment Rules:** Any change to benefits or any plan prohibition relating to terminated or retired employees who return to work.
- Disability:** Any change to the definition of disability or amount paid.
- Hybrid:** The creation of, or change in, a plan that has defined benefit and defined contribution type components.
- Subsidy:** In the case of a retiree medical plan, a change in the percentage of the retiree premium paid by the state.
- Other:** Any other change to the plan affecting the amount or availability of benefits not previously categorized.



# What Other States are Doing to Address Funding Shortfalls

This table shows the types and numbers of actions that states have taken from 2008 to September 2010. During that time period 40 states took at least one action with respect to their pension programs and 15 states took at least one action with respect to their retiree medical program.

Number of Actions Taken by Type			
Pension Plans	Actions	Retiree Medical Plans	Actions
Eligibility	6	Eligibility	5
Compensation	12	Subsidy	4
Benefits Cap	3	Service	1
Multiplier	10	Vesting	1
Service	5	Employer Funding	5
Vesting	5	Employee Contributions	6
Early Retirement	12	Other	1
Normal Retirement	12	Retirement Incentive Program	4
Cost of Living Adjustments	13		
Pension Obligation Bond	2		
Employer Funding	17		
Employee Contributions	16		
Retirement Incentive Program	10		
Re-employment Rules	16		
Disability	3		
Other	3		
Hybrid	6		
<b>Total Actions – Pensions</b>	<b>151</b>	<b>Total Actions – Retiree Medical</b>	<b>27</b>

Source: Developed by Hooker & Holcombe from the reports below on the NCSL Website  
 1. National Conference of State Legislatures: State Pensions and Retirement Legislation 2008  
 2. National Conference of State Legislatures: State Pensions and Retirement Legislation 2009  
 3. National Conference of State Legislatures: State Pensions and Retirement Legislation, September 2010

# What Other States are Doing to Address Funding Shortfalls

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- The most frequent actions taken involve plan funding that either raises the employee contribution rates or adjusts the employer's contribution. The adjustments to the employer's contribution did not always result in the state paying the entire ARC. In order to reduce budgetary pressures, some states have temporarily reduced their contributions.
- In the case of retiree medical, some states that were only paying reported benefits each year, set up programs to phase-in contributions to fund the retiree medical program beyond current benefits.
- States also focused on abuses within their respective systems. Most of these actions related to either compensation or re-employment rules.
- The most common compensation action was changing the averaging period – typically from a three-year average compensation to a five-year average.
- Some states instituted limits on the amount of a compensation increase in a single year that could be included in the average. This was done to eliminate compensation spiking where some employees deliberately boost their salary, and thus their retirement benefits, by working large amounts of paid overtime in the years immediately preceding retirement.
- Other significant actions that reduce costs were to raise the normal retirement age, change the early retirement eligibility or benefit reduction rates, and to lower cost of living adjustments (COLAs) for future retirees and in a few cases, current retirees. In the case of both Colorado and Minnesota, COLA adjustments were across-the-board and lawsuits have been filed in each state to block the actions.
- Finally, ten states implemented retirement incentive programs (RIP) as a means to reduce overall employment costs. Because of these incentives, the unfunded liabilities for either the pension or the retiree medical plans increased. A RIP often utilizes the pension program for a non-retirement goal, with the justification being lower long-term overall employment costs for the state. In order to avoid revolving door employment (where recently incented retired employees return to work), some states modified their re-employment rules to prevent such actions.

# What Other States are Doing to Address Funding Shortfalls

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## Highlights of Specific State Actions

- A review of ARC funding requirements (see next slide: “State ARC Requirements Ranked as a Percent of Total State Budget”) shows that there is a mild correlation with the number of actions certain states are taking and the impact paying both the Pension and Retiree Medical ARC would have on the state’s overall expenditures.
- States like New Jersey have made a number of significant changes to their retirement programs. The pressure that paying the ARCs would put on the state’s budgets is a key factor.
- Although Vermont’s Pension and OPEB ARCs would not have as big an impact on reducing their budget as Connecticut’s ARCs, Vermont’s treasurer and legislature negotiated an agreement with the state’s public employee unions for a series of changes to its teacher’s pension programs that would help reduce the state’s retirement costs and allow longer service teachers to retire with a better benefit at retirement. This was done by raising both the retirement age and employee contributions, thus reducing future costs. Some of this savings was offset by raising the plan’s multiplier for service beyond 20 years and raising the benefit cap from 50% of plan compensation to 60%. Vermont’s treasurer believes the state will initially save \$15 million a year, or about 10% of the state’s current budget shortfall.

# What Other States are Doing to Address Funding Shortfalls

## State ARC Requirements Ranked as a Percent of Total State Budget

	2008 Total State Expenditures — Capital Inclusive (000)	2008 Pension Unfunded Liability (000)	2008 Pension ARC (000)	2006-2008 Retire Medical Unfunded Liability (000)	2008 Retire Medical ARC (000)	Total Pension plus Retire Medical ARC (000) [3]+[5]	Total ARC as a Percent of Expenditures [6]/[1]	Number of Actions Taken [8]
	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]
New Jersey	48,704,000	34,433,509	3,691,740	68,900,000	5,022,100	8,713,840	17.9%	14
Nevada	9,240,000	7,280,310	1,262,758	2,211,439	287,217	1,549,975	16.8%	6
Connecticut	24,536,000	15,859,446	1,248,860	26,018,800	1,718,862	2,967,722	12.1%	2
Michigan	43,982,000	11,516,999	1,249,909	39,879,825	3,946,416	5,196,325	11.8%	4
Hawaii	11,160,000	5,168,274	488,770	10,791,300	822,454	1,311,224	11.7%	1
New Hampshire	4,806,000	2,522,075	251,764	3,054,020	268,848	520,612	10.8%	7
Illinois	46,877,000	54,385,864	3,729,181	39,945,988	1,192,336	4,921,517	10.5%	8
California	194,276,000	59,513,666	12,376,481	62,459,753	5,178,789	17,555,270	9.0%	1
Ohio	56,763,000	16,733,673	2,263,766	27,025,933	2,717,364	4,981,130	8.8%	0
Kentucky	22,995,000	12,328,391	859,305	11,660,884	1,051,372	1,910,677	8.3%	8
South Carolina	20,787,000	12,051,181	902,340	8,637,936	762,340	1,664,680	8.0%	0
Georgia	36,762,000	6,382,995	1,275,881	18,322,794	1,583,008	2,858,889	7.8%	4
Louisiana	29,995,000	11,658,644	1,160,051	12,542,953	1,168,087	2,328,138	7.8%	6
Maryland	29,798,000	10,926,410	1,208,497	14,723,566	1,086,240	2,294,737	7.7%	2
North Carolina	41,587,000	508,006	675,704	28,742,202	2,459,469	3,135,173	7.5%	0
Delaware	8,621,000	129,087	149,614	5,409,410	464,600	614,214	7.1%	0
Washington	31,732,000	(179,266)	1,545,600	7,901,610	682,797	2,228,397	7.0%	1
Missouri	21,179,000	9,022,924	1,219,871	2,851,701	262,215	1,482,086	7.0%	7
Alaska	12,322,000	3,539,112	282,656	4,031,834	558,041	840,697	6.8%	3
Oklahoma	19,962,000	13,173,112	1,245,646	359,800	48,200	1,293,846	6.5%	3
New Mexico	14,790,000	4,519,147	667,691	2,946,421	286,538	954,229	6.5%	8
Maine	7,427,000	2,782,842	305,361	4,347,882	164,045	469,406	6.3%	2
Alabama	40,159,000	9,227,330	1,069,214	15,549,844	1,313,998	2,383,212	5.9%	0
New York	116,056,000	(10,424,619)	2,648,450	56,286,000	4,133,000	6,781,450	5.8%	1
Montana	4,477,000	1,549,926	201,871	631,918	58,883	260,754	5.8%	0
Virginia	35,330,000	10,725,994	1,486,768	2,621,128	541,163	2,027,931	5.7%	7
Utah	12,420,000	3,612,075	641,690	672,824	53,969	695,659	5.6%	4
Pennsylvania	58,696,000	13,728,856	2,436,486	9,956,153	823,500	3,259,986	5.6%	0
Indiana	24,239,000	9,825,968	1,232,347	442,268	45,963	1,278,310	5.3%	1
Idaho	5,930,000	772,282	256,400	489,401	45,494	301,894	5.1%	0
Texas	82,156,000	13,774,752	1,871,409	28,610,003	2,236,952	4,108,361	5.0%	7
Florida	64,379,000	(1,795,837)	3,005,387	3,081,834	200,973	3,206,360	5.0%	1
Kansas	12,689,000	8,279,975	607,662	316,640	16,039	623,701	4.9%	1
Colorado	25,129,000	16,815,441	1,141,081	1,127,196	81,523	1,222,604	4.9%	6
Arizona	24,721,000	7,870,670	1,023,337	808,771	146,198	1,169,535	4.7%	5
Massachusetts	44,146,000	21,762,347	1,226,526	15,031,139	838,700	2,065,226	4.7%	4
Mississippi	15,599,000	7,972,720	662,900	570,248	43,627	706,527	4.5%	4
Arkansas	16,899,000	2,752,133	555,147	1,822,241	170,177	725,324	4.3%	3
Minnesota	28,446,000	10,770,112	1,036,509	1,011,400	109,982	1,146,491	4.0%	9
Tennessee	26,324,000	1,603,073	838,259	1,746,879	167,787	1,006,046	3.8%	2
Rhode Island	7,097,000	4,353,567	219,864	788,189	46,125	265,989	3.7%	7
Wyoming	4,958,000	1,444,085	163,994	174,161	19,292	183,286	3.7%	3
Vermont	5,308,000	461,590	83,579	1,614,523	107,506	191,085	3.6%	10
West Virginia	18,710,000	4,968,629	481,703	6,108,134	174,842	656,545	3.5%	1
Oregon	22,644,000	10,738,054	707,400	609,786	67,126	774,526	3.4%	0
South Dakota	3,150,000	182,613	95,766	76,406	9,429	105,195	3.3%	3
Iowa	16,129,000	2,695,833	453,980	404,300	42,991	496,971	3.1%	7
North Dakota	3,597,000	546,426	80,928	81,271	6,085	87,013	2.4%	1
Wisconsin	36,091,000	255,460	644,800	1,700,499	205,116	849,916	2.4%	0
Nebraska	8,712,000	755,128	169,068	#N/A	#N/A	#N/A	#N/A	3

Source: Budget data was captured from the National Association of State Budget Officers, 2008 State Expenditure Report. Actuarial data was captured from the PEW Center on the States website – Data Visualization. PEW data was crosschecked against some state actuarial reports.

# What Other States are Doing to Address Funding Shortfalls

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- Minnesota, like Vermont, made a series of changes to its program because of budgetary pressure. However, unlike Vermont, Minnesota did not negotiate all its benefit cuts with the employee unions. Actions were taken to increase employee contributions, increase participating municipal employer contributions, reduce cost of living adjustments, increase vesting requirements, and decrease the interest credited on deferred benefits. In addition, Minnesota implemented a retirement incentive program for eligible employees with increased benefits from both the pension plan and the retiree medical plan.
- Minnesota and Colorado made changes to their cost of living policies that affected current retirees as well as future retirees. Both states are being sued by employee groups impacted by the changes.
- Georgia implemented a hybrid design similar to Michigan's for employees on or after January 1, 2009. Under the Georgia plan, an employee receives under the DB component a benefit of 1% times service time salary. Employees are automatically enrolled in a 401(k)-type arrangement for the DC component. Subject to IRS limits, an employee can contribute up to 80% of salary in the DC component. The maximum matching contribution is 5% of salary.

# What Other States are Doing to Address Funding Shortfalls

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- Michigan amended its retirement program in 2010 for its public education employees. Public education employees hired on or after July 1, 2010 will participate in the hybrid plan, where for the DB component of their benefits<sup>1</sup>, they will contribute \$510 annually plus 6.4% of salary above \$15,000. With respect to the DC component of the plan, employees contribute 2% of salary, and employers will provide a 50% matching contribution. Employees have the option to increase their personal contributions up to the annual IRS limit. As of 2010, the limit is \$16,500. Employers may locally negotiate higher matches than the required 1%, not to exceed a total match of 3%, for an employee contribution of 6%. Any additional employer match beyond 1% is at the discretion of the employer, and is decided annually. An employer<sup>2</sup> may negotiate matches for employees who are not in the hybrid plan and who wish to participate by making employee contributions into the DC component of the hybrid plan. Any entity receiving full or partial, direct or indirect funding from the School Aid Fund, and not participating in the Michigan Public School Employees Retirement System (MPSERS), may opt into the hybrid retirement plan for its employees, upon approval by the IRS. In addition, existing MPSERS employees hired before July 1, 2010 may opt into the DC component of the hybrid plan without an employer match. The revised hybrid plan is estimated to save \$1.2 million in the first year and \$129.4 million over 10 years.

<sup>1</sup> The formula is 1.5% times credited service.

<sup>2</sup> Employers of the plan are public schools and universities.

# What Other States are Doing to Address Funding Shortfalls

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## What Connecticut has Done

• Since 2008 Connecticut has taken two actions:

1. With the first action, the state implemented a retirement incentive plan to reduce the size of the state workforce. The incentives were directed to employees close to or eligible for retirement and provided incentives in the form of reduced retirement requirements, cash, or increased retirement benefits (e.g., three additional years of service credit). Several reforms were made to the retiree medical program eligibility and co-pay rules.
2. With the second action, the state requires new employees to contribute 3% of their pay for the first ten years of service.

• These retirement incentives and reforms were negotiated with the State Employees Bargaining Agent Coalition (SEBAC 2009) and as a part of the agreement; the state was allowed to defer current and future Annual Required Contributions (ARC) to future years. The Governor stated the retirement incentive plan would save of approximately \$194 million over two years. However, this amount excludes the future costs associated with the deferred contributions.

• Given the funding status of its plans, Connecticut has lagged behind other states in the number and magnitude of actions with states like New Jersey with similar significant unfunded liability problems taking a significant number of actions to reduce costs associated with both the retiree medical and the pension plans. As shown in the table “State ARC Requirements Ranked as a Percent of Total State Budget,” assuming it was contributed, Connecticut’s ARC as a percent of expenditures is one of the highest in the United States; yet the number of actions it has taken to control costs is one of the lowest.

# What Other States are Doing to Address Funding Shortfalls

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## Conclusions and Recommendations

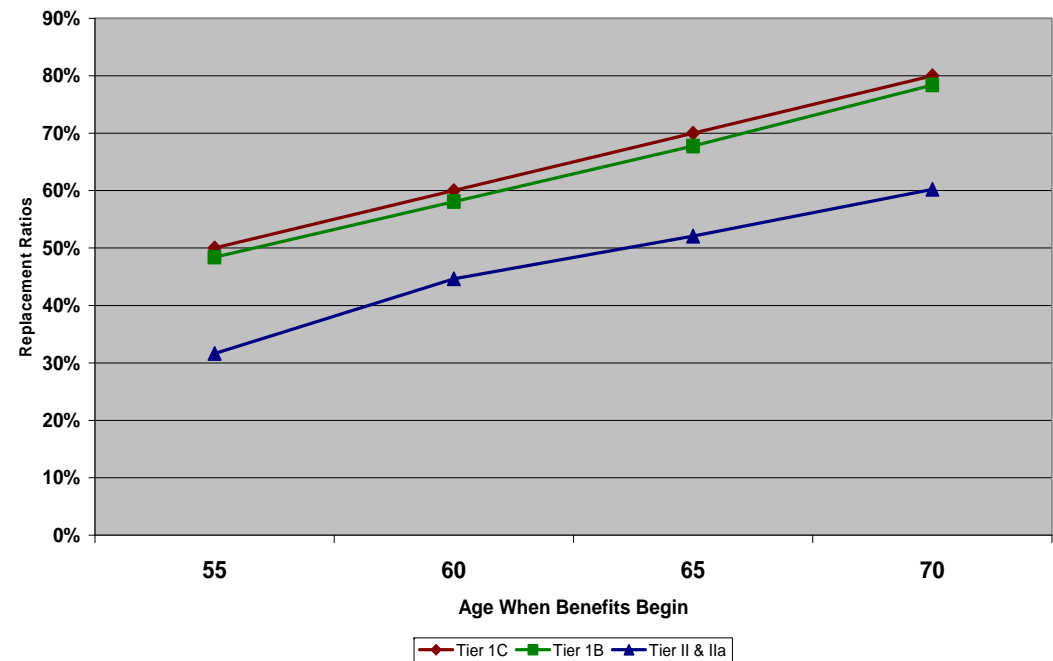
- The Governor stated the retirement incentive plan would save of approximately \$194 million over two years. However, this amount excludes the future costs associated with the deferred contributions.
- Given the funding status of its plans, Connecticut has lagged behind other states in the number and magnitude of actions with states like New Jersey with similar significant unfunded liability problems taking a significant number of actions to reduce costs associated with both the retiree medical and the pension plans.
- As shown in the State ARC Requirements table, Connecticut's ARC as a percent of expenditures is one of the highest in the United States; yet the number of actions it has taken to control costs is one of the lowest.



# Connecticut's Pension Tiers

- This table shows the progression of replacement ratios<sup>1</sup> for a participant who is hired at age 30, performs in a non-hazard duty status and remains in employment to qualify for a monthly annuity at separation. Replacement ratios are based on a final average salary equal to \$75,000 at retirement.
- The graph shows that when legislature created the Tiers II and IIa benefit set, there was a significant reduction in monthly retirement benefits for that group. However, Connecticut state employees also are members of the Social Security System and, depending on how many years they are in the system, a member could get as much as an additional 30%-40% of his or her salary replaced by social security when attaining social security retirement age.

Comparison on Replacement Ratios as a Percent for Tier 1C, 1B, II & IIa Benefits for an Employee Hired at Age 30 and Beginning Benefits in 2009



<sup>1</sup> A participant's Replacement Ratio is the percentage of monthly benefit the participant receives in relation to his or her final average salary.

Graph Source: Calculated by Hooker & Holcombe, Inc. This was a hypothetical calculation using the retirement formulas described in the 2008 Actuarial Valuation for each Tier.

# Connecticut's Pension Tiers

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## Tier IC, IB, II, and IIa Retirement Benefits

- For non-hazard duty employees there is a significant reduction in benefits for employees covered under Tiers II and IIa benefit structures compared to the Tiers IC and IB. For non-hazard duty employees, Tiers IC and IB benefits make up 48% of the liabilities for active non-hazard duty employees based on the 2008 SERS Actuarial Evaluation. Both Tiers IC and IB continue to accrue higher benefits under the plan as compared to the Tiers II and IIa employees.
- It should also be noted that for hazard duty employees the reduction in benefits from Tiers IC and IB to Tiers II and IIa were not as significant.<sup>1</sup> For that reason, the report provides no comparison.

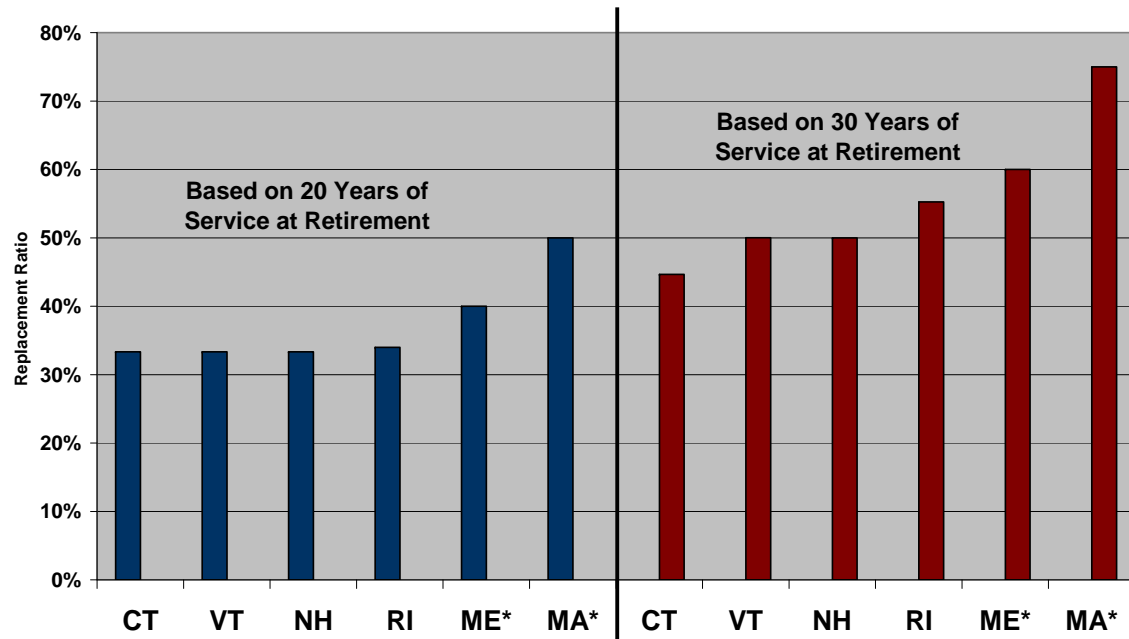
<sup>1</sup> For hazard duty employees, the Tier I retirement benefit formula was 50% plus 2% for each year of service in excess of 20 years and the result multiplied by final average salary. Normal retirement is 20 years of service. For Tiers II and IIa, the formula is 2.5% for the first 20 years service plus 2% for each year of service in excess of 20 years. Normal retirement is 20 years of service. Under certain age and service conditions Tier II and Tier IIa hazard duty employees can retire with less than 20 years with a lower benefit.

# Connecticut's Pension Tiers

## Tier IIa and Retirement Benefits Offered in Other New England States

This table compares Connecticut's Tier IIa benefits, which is the benefit structure for new hires with the benefit structures of neighboring New England states. Connecticut's Tier IIa benefits appear to be in line with other New England states.

Connecticut's Tier IIa Employees' Retirement Replacement Ratios  
 Compared to other New England State Employees  
 Ratios as a Percent of Final Average Salary \$75,000

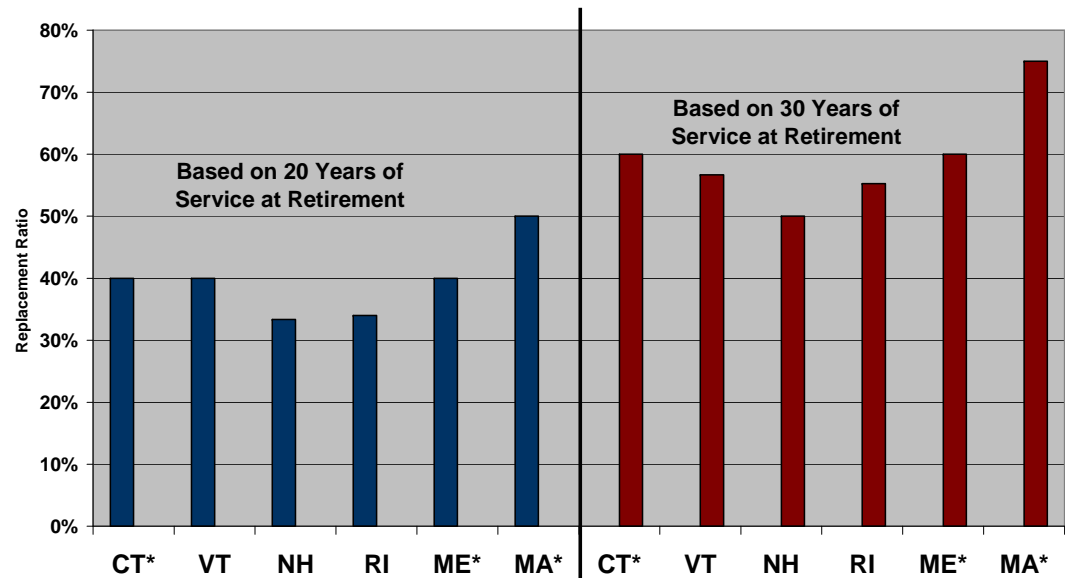


Source: Calculated by Hooker & Holcombe, Inc. This was a hypothetical calculation using the retirement formulas described on the state website for the each state plan in New England.

# Connecticut's Pension Tiers

- This table compares Connecticut's Teachers benefits with surrounding states. When you factor in Social Security retirement benefits, Connecticut Teachers are in the lower third of the group with benefits comparable to Maine.
- Connecticut's Retirement System is administered in accordance with the state's General Statutes. The current SEBAC agreements remain in effect until June 30, 2017.

Connecticut's Teachers' Retirement Replacement Ratios  
 Compared to other New England State Teachers  
 Ratios as a Percent of Final Average Salary \$75,000



Source: Calculated by Hooker & Holcombe, Inc. This was a hypothetical calculation using the retirement formulas described on the state teachers' website for the each state teachers' plan in New England.

# Connecticut's Pension Tiers

- This table shows the expected Connecticut contribution to the State Employees Retirement System (SERS) for 2009 and 2010 for the plan's normal cost. The normal cost does not include a contribution for the plan's unfunded liability which is approximately 15.5% of payroll in 2009 and approximately 16% of payroll in 2010.<sup>1</sup>
- Tier I employees have a significantly higher cost because the group not only has better benefits than the other tiers but the Tier I group on average is older, has longer service, and has higher salaries. For Tier IIa employees, the normal cost as a percentage of payroll in 2032 and thereafter is expected to be approximately 13.5% for Tier IIa hazardous duty employees and 6.8% for all other Tier IIa employees.<sup>2</sup> This assumes that the plan remains unchanged and that by 2032 only Tier IIa employees remain in the plan. Dr. Thomas Woodruff, Director Healthcare Policy & Benefit Services, Office of the Comptroller, in a note to the Post Employment Benefits Commission indicated with respect to Tier IIa that: "According to the SERS actuaries at the time, the normal cost for Tier II-A is expected to increase as that population ages but should settle somewhere between 7% and 8% of payroll."<sup>3</sup>

<sup>1</sup> Pages 28 and 29 of the 2008 State Employees Retirement System Actuarial Valuation. Amortization percentages were determined by dividing Net Amortization Payment by Projected Payroll.

<sup>2</sup> Letter dated February 1, 2007 from Milliman to Dr. Thomas Woodruff, Director Retirement Benefits Division.

<sup>3</sup> The note is not dated and it is not clear if the normal cost projection is from the same project mentioned in the February 1, 2007 letter from Milliman to Dr. Thomas Woodruff.

Normal Cost as a Percent of Payroll*		
	June 30, 2009	June 30, 2010
Tier I Hazardous Duty	12.81%	12.59%
Tier I Plan B	14.14%	14.34%
Tier I Plan C	11.28%	11.48%
Tier II Hazardous Duty	14.87%	14.82%
Tier II All Others	9.93%	10.10%
Tier IIA Hazardous Duty	7.28%	7.62%
Tier IIA All Others	4.56%	4.55%
Total	9.22%	9.01%

**\* 2008 State Employees Retirement System Actuarial Valuation**

# Connecticut's Pension Tiers

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## Status of Benefits Provided to State Employees<sup>1</sup>

- For Connecticut there is no explicit constitutional protection for public pension benefits. Statutory protection exists for vested employees who satisfy eligibility requirements by becoming eligible to receive benefits. Courts have also recognized that the state's statutory pension scheme establishes a property interest entitled to protection from arbitrary legislative action under the due process provisions of the state constitution. See *Pineman v. Oechslin*, 488 A.2d 803 (1985).
- Municipal pensions are protected by CT Stat. § 7-148 which provides that the “rights or benefits granted to any individual under any municipal retirement or pension system shall not be diminished or eliminated.”

<sup>1</sup>Source: NCPERS - State Constitutional Protections for Public Sector Retirement Benefits – 3/15/2007

# Connecticut's Pension Tiers

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## Conclusions and Recommendations

- When benefit programs are trimmed in some manner, many states will create a new “tier” of eligible employees. Usually the new tier will be made up of future employees and employees that are not yet eligible for benefits at the time the plan was amended.
- The rationale for this approach generally rests with the state law. Some states have constitutional protections that prohibit the state from diminishing a state employee's benefits that would be payable under the plan's terms in effect as of the date the employee first became eligible to participate in the plan.
- States like Michigan and Hawaii follow ERISA type rules that only protect benefits that have accrued as of the date of the plan change – benefits for all employees can be changed prospectively.
- Still others have court rulings based on contract law that provide protections for past benefits and in some cases future benefits.
- It would appear that Connecticut does not have constitutional prohibitions to modify the benefit program. Connecticut has followed a practice of grandfathering future benefits for current employees and thus the tiered benefit structures in the plan.
- Whether there is a legal requirement to grandfather protection for both past and future benefits is unclear. Michigan, Hawaii, and some other states protect benefits that have been earned to-date (i.e., past benefits) and leave open the possibility that future benefits will be different. This approach has been used by the private sector and was codified in ERISA.
- Protecting only benefits earned to date affords the state the opportunity to provide both protection for employees and across the board solutions in managing its workforce and costs.

# Considerations for a Defined Contribution Plan

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- Thirteen states have some form of defined contribution arrangements for their employees as a part of their primary benefit program.<sup>1</sup> In some cases, the DC arrangement has been combined with a scaled down DB component plan. In the public sector these combination arrangements are often characterized as hybrid<sup>2</sup> plans.
- Besides the traditional DB plan are there any other options? Unlike traditional DB plans which focus on a specific benefit amount at retirement, DC plans focus on the specific contribution the employer (i.e., the states, municipality, etc.) and participant will make currently. The participant's contributions are placed in an investment account that accumulates until retirement. Depending on the plan's rules, at retirement the participant receives a lump sum distribution of the account or an annuity based on the account's value. The size of the account depends on the amount contributed and the investment earnings on the account. A nontraditional DB that behaves in many ways like a DC plan is the Cash Balance (CB) Plan.<sup>3</sup>

<sup>1</sup>This excludes 457 and 403(b) plans.

<sup>2</sup>In the private sector, a hybrid plan is a defined benefit plan that has features similar to a defined contribution plan. In the public sector, the term is used to characterize a retirement program with a defined benefit component and a defined benefit contribution component which together provide an employee's retirement benefit under the plan.

<sup>3</sup>In CB plan, the participating employee receives contribution credits. These credits are accumulated to retirement at an interest rate specified in the plan. The interest rate can be a floating rate, fixed rate, or a combination. At separation, the employee can receive an annuity based on rates specified by the plan. Generally, an employee in the CB plan can receive no less than the sum of the contribution credits.



# Considerations for a Defined Contribution Plan

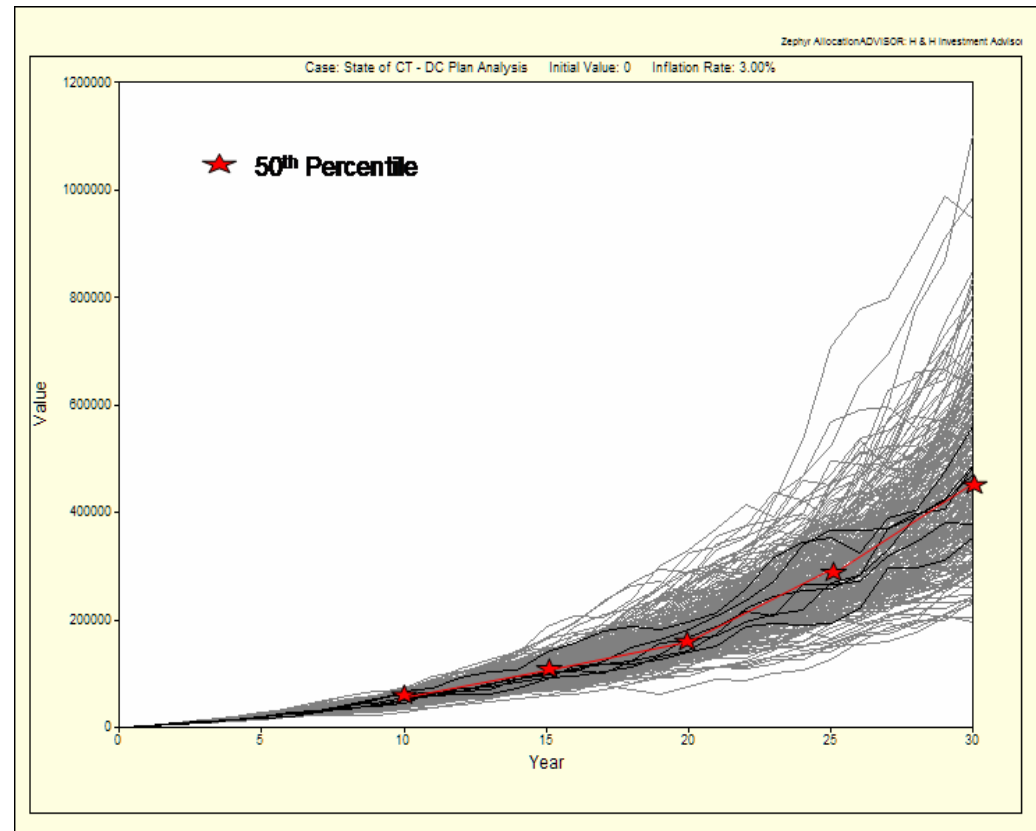
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## An Example of an Implemented Hybrid Plan

- Nebraska has a combined DB/DC arrangement. The DB arrangement is a cash balance plan and the DC arrangement is a traditional DC plan where employees can allocate contributions and account assets to a suite of investment funds. Employees can choose to participate in either a CB plan (i.e., the DB plan) or the DC plan.
- If an employee participates in the CB plan, his or her contribution credits will accumulate at a defined interest credit rate. The interest credit rate as defined by statute is the greater of 5% or the federal mid-term rate plus 1.5%.
- Employees who participate in the DC plan can invest their monies in a variety of funds and earn whatever the funds they invest earn.
- Employees at retirement can receive their account balance as a lump sum whether they participated in the CB or the DC plan. For employees choosing annuity options, DC participants will receive a competitive annuity conversion rate and CB participants as an integral part of the CB benefit receive a higher (i.e., better) annuity conversion rate.

# Considerations for a Defined Contribution Plan

- This table represents a Monte Carlo simulation of the accumulation pattern an employee could experience who participated only in a DC plan throughout his or her career.
- The graph assumes that the employee is earning approximately \$33,000/yr at hire (Year 0) and averages in the final three years \$75,000/year at retirement (Year 30). The employee's salary increases at the 3% inflation rate each year.
- The employee through a combination of state contributions and employee contributions contributes to an investment account 10% of salary each year. The account is invested at all times in a diversified portfolio — 60% in equity and 40% in fixed income securities. The expected yield is 7.5%. The expected value of the account is about \$460,000. It is possible to see from the graph a substantial number of scenarios fall above and below that amount.



Source: Calculated by Hooker & Holcombe, Inc. This is a Stochastic projection of an employees hypothetical account balance.

# Considerations for a Defined Contribution Plan

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- Assuming an employee accumulated the \$460,000 account balance and converted the balance at age 65 into a life annuity with a 2.5% COLA, the first year annualized annuity would be about \$30,400.
  - Note: This assumes the annuity conversion rate is based on 5% interest and current mortality rates under the Pension Protection Act of 2006.
  - Thus the expected replacement of income at retirement is about 40.5%. If the employee has an additional 40% of income replaced by Social Security, the overall replacement ratio would be 80.5%.
- Because there is a wide range of outcomes, a state cannot easily know whether the DC plan is meeting the retirement needs of employees. The same contribution rate that is adequate for one cohort of employees could turn out differently for another group.
- It is also important to recognize that there have been a number of products developed in the financial sector that attempt to minimize the risk of asset volatility causing employees to fall short of their retirement goals (e.g., stable value funds, lifecycle funds, model portfolios, target date funds, variable annuities to name a few).
- This probability pattern is the same risk/reward model that private sector employees experience in DC plans.

# Considerations for a Defined Contribution Plan

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**From Connecticut's perspective there are pros and cons in switching to a hybrid or DC arrangement.**

•Pros

- Investment and longevity risk is borne by the employee.
- Annual contributions are more predictable. Volatility is driven mostly by workforce management practices not by investment performance.
- Avoids the triple whammy during tough economic times of (1) increasing unfunded pension liabilities, (2) lower tax revenues, and (3) increasing demands on state services.
- Popular with younger workers because the account balance is portable. Helps recruitment.
- Easy to communicate the program to employees.

•Cons

- Can be disruptive to workforce management policies. In bad economic times when account balances may be low, employees may opt to delay retirement. In good economic times when balances may be high, employees may choose to retire earlier than desired by the state.
- DC plans allowing employees to manage their account require a significant commitment to investment education for the employees.
- Disability benefits will have to be addressed outside of the plan.
- Employees may use lump sum benefits at termination for purposes other than retirement.
- Because the contribution is defined, the amount to be contributed is inflexible. Unlike a DB plan, a state cannot forego its DC contribution or under-contribute and make up the shortfall in another fiscal year.

•In order to evaluate the implementation of a DC arrangement as either a replacement to the DB plan or combined with a scaled-down DB plan, we would strongly recommend that the state identify the basic principles and policies they will apply to providing retirement benefits to state employees. See the section of this report on **Policy Considerations**.

# Considerations for a Defined Contribution Plan

## Conclusions and Recommendations

•In order to evaluate the implementation of a DC arrangement as either a replacement to the DB plan or combined with a scaled-down DB plan, we would strongly recommend that the state identify the basic principles and policies they will apply to providing retirement benefits to state employees. See the section of this report on **Policy Considerations**.

•Currently 13 state employee retirement programs that have included a defined contribution type arrangement as a part of the retirement benefits.

•These programs are either patterned after DC offerings in private industry (e.g., Alaska and Michigan) or in a private industry type hybrid form such as Nebraska or with an employee choice between the a DB plan or DC plan.

•There is a growing debate in the public sector about the benefits of offering defined contribution plans in lieu of the defined benefit plans that are currently in place.

•As was the case in the private sector a significant motivating factor is the growth in cost defined benefit plans.

•Because of growing unfunded liabilities in their DB plans, Michigan and Alaska have closed down their DB plans to new entrants and offer only a defined contribution plan.

States with DC or Hybrid Plans	
Alaska	DC
Colorado	DB/DC Choice
Georgia	Hybrid
Florida	DB/DC Choice
Indiana	Hybrid
Michigan	DC
Montana	DB/DC Choice
Nebraska	Hybrid
North Dakota	DB/DC Choice
Ohio	DB/DC Choice
Oregon	Hybrid
South Carolina	DB/DC Choice
Washington	Hybrid

Source; The list of states came from the NCSL Website and the following report [National Conference of State Legislatures: State Defined Contribution and Hybrid Pension Plans, June 2010](#). The classifications were made by Hooker & Holcombe, Inc. after reviewing the plan description on each state's website.

# Retiree Medical

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- Retiree medical benefits are offered by all states as a part of their overall benefits package available to their employees and their employee dependents.
- Most states have funded their retiree medical programs on a pay as you go basis. After December 15, 2005, the Government Accounting Standards Board rules required reporting and the measurement of OPEB liabilities and expense. The rules essentially allowed a state to value its liabilities using a spectrum of interest rates based on the level of the program's funding, the expected return on the portfolio, and the state's general funds rate.
- As a consequence, some states enacted programs to begin funding their future retiree medical costs. Based on the data from the Pew Center on the States "*The trillion dollar gap, Underfunded state retirement systems and the roads to reform*" there are 29 states that had some assets funding of their OPEB plans.<sup>1</sup>

<sup>1</sup>Nebraska did not provide PEW with OPEB liabilities data

# Retiree Medical

- As states have become more aware of the magnitude of their liabilities, they have taken actions to control their costs. This table shows the number and type of actions that have been taken by states.
- By far the most common action has been to increase the funding of the plans. Generally, this has meant the adoption of a funding policy that phases the state into meeting the GASB ARC for the OPEB plans.
- States have also implemented rules tightening eligibility requirements and the amount they subsidize. For instance, Vermont implemented a new tier in 2010 that provides for no subsidy of the insurance premium for employees with less than 15 years of service. From 15 years of service the subsidy grades up in steps from 60% to 80%.

Number of Actions Taken by Type	
Retiree Medical Plans	Actions
Eligibility	5
Subsidy	4
Service	1
Vesting	1
Employer Funding	5
Employee Contributions	6
Other	1
Retirement Incentive Program	4
<b>Total Actions – Retiree Medical</b>	<b>27</b>

# Retiree Medical

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- It is important to note that within a retiree medical program there can be two forms of subsidy being provided.
  1. One subsidy, an implicit subsidy, occurs when the retiree's annual or monthly premium is determined without regard to employment status and includes the claim experience of active and retired employees and beneficiaries. Generally the retiree claim experience will be higher than the premiums attributed to the retirees and this difference is the implicit subsidy.
  2. The second subsidy, an explicit subsidy, is the portion of the employee's premium the state specifically picks up by reducing the employee's premium. Thus the state may pay a percentage of a retiree's premium explicitly but the total premium may not be sufficient to pay expected claims for the retiree thus the state makes up the difference in the implicit subsidy.
- As a general rule the implicit subsidy increases with the amount of time a retiree can receive health benefits. Thus the earlier employees are allowed to retire and receive health benefits the greater the state's cost for both explicit and implicit subsidies.
- In reviewing the actions taken, states did not attempt to reduce their costs by significantly changing the benefits themselves. Their actions were focused mainly on the eligibility and funding.



# Retiree Medical

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## New Hampshire's New Funding Concept

- New Hampshire's new funding concept has widespread support from the state employee unions, the politicians, and the executive branch.
- The state currently provides a \$4,500 annual subsidy to retirees for health insurance.
- When the new plan is implemented, state and municipal employees will make tax-free contributions to a Retiree Medical Trust which will be managed by the employees through their respective unions. In addition to tax free status employee contribution will not be subject to payroll taxes which is a savings for the state. The contributions to the medical trusts and the investment returns can be used by the employees when they retire to pay health premiums and qualified healthcare expenses.<sup>1</sup>
- The money distributed to the retirees for health care premiums and expenses would be not be taxed. The overriding reasons for New Hampshire implementing this type of arrangement was (1) severe budgetary constraints for the state and towns and (2) the willingness of state and municipal employee unions to try this funding arrangement as an alternative to benefit cuts.

<sup>1</sup> It is not clear whether the medical trust will be setup either with individual accounts or a pooled account.

# Retiree Medical

## Conclusions and Recommendations

- This table shows how Connecticut has one of the highest retiree medical unfunded liabilities in the nation when looked on a per capita basis.

- Its ARC on a per capita basis is also among the highest in the nation.

- The amount of the ARC directly relates to the number of state employees and beneficiaries covered, the amount of time they are covered, the richness of the benefits, and the amount the state subsidizes the program verses what the retirees and employees pay.

- Given these parameters of cost, it is very understandable why states that took some action on there retiree medical plans focused on eligibility, subsidies, and employee contributions.

Source: Calculated by Hooker & Holcombe, Inc. from the data below:  
 U.S. Census Bureau: Reported Voting and Registration of the Citizen Voting-Age Population, for States: November 2008  
 Pew and the Center on the States: The Trillion Dollar Gap.

	2008 Voting Age Citizens by State (000) [1]	2006-2008 Retire Medical Assets (000) [2]	2006-2008 Retire Medical Unfunded Liability (000) [3]	2008 Retire Medical ARC (000) [4]	ARC per Voting Age Citizen [4]/[1] [5]	Unfunded Liability per Voting Age Citizen [3]/[1] [6]
Hawaii	882	0	10,791,300	822,454	932	12,232
New Jersey	5,674	0	68,900,000	5,022,100	885	12,143
Connecticut	2,396	0	26,018,800	1,718,862	717	10,860
Delaware	606	79,591	5,409,410	464,600	766	8,923
Alaska	468	5,114,795	4,031,834	558,041	1,193	8,621
Michigan	7,176	788,975	39,879,825	3,946,416	550	5,558
Illinois	8,684	76,042	39,945,988	1,192,336	137	4,600
Alabama	3,407	400,350	15,549,844	1,313,998	386	4,564
North Carolina	6,474	622,532	28,742,202	2,459,469	380	4,440
West Virginia	1,388	254,506	6,108,134	174,842	126	4,402
New York	12,855	0	56,286,000	4,133,000	321	4,378
Maine	1,006	51,918	4,347,882	164,045	163	4,324
Louisiana	3,057	0	12,542,953	1,168,087	382	4,103
Maryland	3,823	118,738	14,723,566	1,086,240	284	3,851
Kentucky	3,094	1,347,688	11,660,884	1,051,372	340	3,769
Vermont	476	3,722	1,614,523	107,506	226	3,392
Massachusetts	4,537	273,961	15,031,139	838,700	185	3,313
Ohio	8,371	16,733,673	27,025,933	2,717,364	325	3,229
New Hampshire	994	175,355	3,054,020	268,848	270	3,071
California	21,811	6,247	62,459,753	5,178,789	237	2,864
Georgia	6,516	777,377	18,322,794	1,583,008	243	2,812
South Carolina	3,201	153,856	8,637,936	762,340	238	2,698
New Mexico	1,351	170,495	2,946,421	286,538	212	2,180
Texas	15,036	730,581	28,610,003	2,236,952	149	1,903
Washington	4,600	0	7,901,610	682,797	148	1,718
Nevada	1,715	0	2,211,439	287,217	168	1,290
Pennsylvania	9,210	92,447	9,956,153	823,500	89	1,081
Rhode Island	752	0	788,189	46,125	61	1,048
Arkansas	2,030	0	1,822,241	170,177	84	898
Montana	723	0	631,918	58,883	81	874
Missouri	4,325	15,771	2,851,701	262,215	61	659
Virginia	5,313	1,341,872	2,621,128	541,163	102	493
Idaho	1,049	4,345	489,401	45,494	43	467
Wyoming	389	0	174,161	19,292	50	448
Wisconsin	4,055	536,705	1,700,499	205,116	51	419
Tennessee	4,533	0	1,746,879	167,787	37	385
Utah	1,768	4,675	672,824	53,969	31	380
Colorado	3,374	258,758	1,127,196	81,523	24	334
Mississippi	2,065	0	570,248	43,627	21	276
Minnesota	3,679	0	1,011,400	109,982	30	275
Florida	12,462	0	3,081,834	200,973	16	247
Oregon	2,689	258,607	609,786	67,126	25	227
Arizona	4,169	1,513,949	808,771	146,198	35	194
Iowa	2,138	0	404,300	42,991	20	189
North Dakota	476	42,505	81,271	6,085	13	171
Kansas	1,926	0	316,640	16,039	8	164
Oklahoma	2,567	0	359,800	48,200	19	140
South Dakota	575	0	76,406	9,429	16	133
Indiana	4,559	0	442,268	45,963	10	97
Nebraska	1,254	#N/A	#N/A	#N/A	#N/A	#N/A

# Retiree Medical

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- Connecticut modified its retiree health eligibility rules in 2009. New employees after July 1, 2009 will be required to have at least 10 years of service or based on age and service meet the rule of 75. In addition, new employees will contribute 3% of pay for the retiree medical plan for their first ten years of service.
- In addition to age and/or service related requirements, eighteen states require some form of participation in the state health insurance plan or employment with the state within 1 year – sometimes less – of applying for benefits under the retiree medical plan.
- This rule means that unlike in Connecticut, a person cannot work for the state for 10 years and become vested and then leave state employment for another employer and then return many years later to collect retiree medical benefits.
- Unlike Connecticut which generally pays the entire premium, sixteen states determine the amount of premium subsidy based on service.
  - Rhode Island requires certain ages to be met for eligibility and then provides a premium subsidy beginning at 50% with 10 years of service and grading up to 100% at 28 years of service.
- Connecticut must define the policy objectives for retiree medical benefits. See Policy Considerations section.
- Connecticut should look to other states to find examples and best practices to better manage retiree medical benefits.

# Policy Considerations

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**In order for Connecticut to have and maintain an adequate retirement program for its employees, a number of policy questions need to be asked and answered:**

- What is the business case for a state offering a both pension and retiree medical program to its employees? For example, if the purpose is to attract and retain employees, then how attractive must the program be?
- For career employees, should the state provide an adequate benefit at retirement as in a DB plan or is it the state's responsibility to provide the opportunity for an adequate retirement benefit as in a DC plan? In other words, is the primary purpose of the plan going to be retirement income or wealth accumulation?
- Should the state retirement programs be regularly updated to mirror what is available to private sector workers?
- Should the state be allowed to amortize negotiated benefit increases well beyond the expected service of the employees impacted?
- Should actuarial gains and losses be amortized differently from benefit increases?

# Policy Considerations

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- Should the state continue to set-up benefit tiers that give some employee groups much better benefits for both past and future service because of when they were hired?<sup>1</sup>
- Should investment performance as well as inflation be considered with respect to COLA's?
- What is the most that a state is willing to pay for a retirement program in good times and bad? A follow-up to this question would be: How does the cost of the state's retirement program factor into state hiring policy, furlough programs, sick leave, etc.?
- How should unexpected events like the 2008 meltdown be handled? What is the balance between the taxpayers' interests and the employees to solve the issues these events cause?
- Should an employee be able to work 10 years and receive lifetime retiree health benefits many years later when they retire?
- How much should the state subsidize health benefits?
- Beyond federally mandated coverage, what obligations does the state have with respect to dependent health care? Should dependents be subsidized differently?

<sup>1</sup> Private sector DB plans because of ERISA do not cut back benefits earned from past service. However, an employer is free to change the benefits that will be earned in the future. Public plans often set up benefit tiers based on when an employee was hired. When there is a need to reduce the cost or growth of future benefits, the public employers will often make benefit reductions effective for future hires and allow current employees to earn benefits under the old formula even when the costs created by the old formula are part of the issue. Thus the reductions, from the perspective of the retirement program, are born only by the new employees.

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- f. **Florida Retirement System:**
- g. **Employees Retirement System of Georgia**
- h. **Teachers Retirement System of Georgia**
- i. **Indiana Public Employees Retirement Fund**
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- k. **Maine State Retirement System**
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- m. **Massachusetts Teachers Retirement System**
- n. **Michigan Public School Employees Retirement System**
- o. **Michigan State Employees' Retirement System**
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