COALITION TO PRESERVE THE DEFINED BENEFIT SYSTEM

IRS Hearing on Proposed Regulations
on Age Discrimination in Retirement Plans

April 9, 2003

Testimony by
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on behalf of the Coalition to Preserve the Defined Benefit System

Hello and thank you for the opportunity to appear today. My name is Kathy Cissna and I am Director of Retirement Plans at R.J. Reynolds. I am appearing today on behalf of the Coalition to Preserve the Defined Benefit System, a broad-based employer coalition formed in response to the proposed regulations we are discussing today. The Coalition's 58 member companies, which range from small organizations to some of the largest corporations in the U.S., sponsor defined benefit plans covering more than one million participants.

Coalition members, like R.J. Reynolds, believe in defined benefit plans and believe in the secure benefits these plans deliver to employees. Yet the challenges we face as defined benefit plan sponsors today are unprecedented. From the precarious state of the economy...to record asset declines...to the inflated financing obligations imposed by the obsolete 30-year Treasury bond rate, today's pension environment is truly inhospitable. Despite the good intentions and dedication shown by the agencies involved in this regulatory process, the Coalition believes the regulations we discuss today, if not revised substantially, will aggravate this situation.

The proposed regulations would invalidate many long-standing plan structures and features. They would also limit flexibility and innovation in pension design, further complicating plan administration. In light of the many other stresses on the defined benefit system, the Coalition fears that these negative outcomes -- if not avoided through modification of the proposed regulations -- could prompt additional employers to curtail or abandon their defined benefit programs.

To illustrate, over the past several weeks, the Coalition has surveyed 90% of the Fortune 100 and determined that the proposed regulations' expansive new interpretation of age discrimination would invalidate over two-thirds of Fortune 100 defined benefit plans. In the interest of time, we mainly looked at the formulas of the primary salaried plans. This was not an exhaustive review of plan amendments, grandfather provisions or secondary plans. But we are confident that if a total review was possible, the failure rate would be considerably higher.

It is important to note that many of the plans that failed would never have been suspected of age discrimination absent the proposed regulations. They failed based on long accepted, common employee-friendly provisions such as Social Security offsets, indexing of career average or frozen benefits, or reflecting early retirement subsidies in opening balances in cash balance plans.

Let me be clear that the Coalition sincerely appreciates the effort of the Treasury Department and IRS in developing these proposed rules. Providing greater certainty in the legal rules applicable to hybrid pension plans is critically important, and we recognize the complexity and controversy associated with this task. The Coalition appreciates the positions reflected in the proposed regulations that the cash balance design is not age discriminatory, and that conversions to cash balance plans can be performed in a manner that complies with age discrimination requirements.

Additionally, let me express the gratitude of the Coalition for the withdrawal of the nondiscrimination portion of the proposed regulations earlier this week. The proposed application of the new comparability rules to cash balance plans was an area of significant concern for the Coalition, undercutting a number of conversion approaches sponsors have used to protect long service employees in cash balance conversion situations. We appreciate Treasury and IRS' reconsideration of this vital and complex issue.

Background on Hybrid Plans

Given that the effect of the proposed regulations on hybrid plans has been the source of much of the testimony you have heard, let me briefly review some background on hybrid plans.

These plans, most notably cash balance and pension equity, were developed to correct a mismatch between the traditional pension design and the needs of today's workers. The traditional pension design awards a disproportionate share of benefits to the small number of employees with very long service, but it provides disappointing benefits for the vast majority of employees with less than career-long service at a single firm.

Hybrid plans respond to this reality with a more even benefit formula that delivers benefits equitably to short, medium and long-service employees. In fact, when costs are held neutral, hybrid plans deliver higher benefit levels for nearly 80% of workers. Hybrid plans also provide features that many employees desire, such as greater portability and an account-based benefit that is more tangible.

It was for many of these reasons that R.J. Reynolds adopted the first pension equity plan in 1993. While our workforce continues to include many long-service employees, we had begun to see an influx of mid-career hires and shorter tenures – situations that were not well-served by our existing defined benefit plan. A pension equity plan allowed us to preserve the retirement security advantages of a defined benefit plan -- employer funding and investment management, federal government insurance, and spousal protections -- while delivering more meaningful benefits to employees with increasingly diverse work patterns and tenures.

As is the case for the majority of employers that have moved to hybrid designs, the purpose of our conversion was to spend our current pension dollars in a smarter way that would deliver meaningful benefits to more of our employees.

Restrictive General Rule for Defined Benefit Plans

Let me move to the Coalition's specific comments on the proposed regulations. One of our chief concerns is the restrictive general rule that applies to defined benefit plans, and the extremely divergent way in which the regulations treat defined contribution and cash balance plans on the one hand, and all other defined benefit plans on the other hand.

The general rule will often force employers with defined benefit plans to spend ten times more on older employees than younger employees, despite the fact that equal contributions for such employees are sufficient to satisfy age requirements for defined contribution and cash balance plans.

This is because under the proposed general rule, one must compare the annual accruals of an annuity benefit payable at normal retirement age for workers at different ages. If a younger employee accrues an annuity starting at age 65 of one percent of final average pay, an older employee generally must accrue as much or more. Yet the cost of an annuity starting at age 65 can be more than ten times as great for a 65-year-old as for a 25-year-old. Nonetheless, the proposed regulations require these extremely divergent contributions in many instances.

If the equal contribution approach is a fair standard for age discrimination for the 80 percent of all plans today that are defined contribution or cash balance, it should be a fair standard for the defined benefit plans that make up the remaining 20 percent of retirement plans.

Restrictive Standard for Plan Design and Plan Amendments

We believe that one unfortunate consequence of the proposed regulations is that it will push plan design into two limited categories: traditional final average pay with no unique features, or cash balance and defined contribution.

Defined benefit designs with accrual patterns between these two poles (pension equity, for example) or that in some respect diverge from the most basic final average pay plan (such as contributory plans, integrated plans and indexed plans) will satisfy neither the restrictive general rule nor the narrow cash balance safe harbor. This poses problems for many plans today and will inhibit the development of future designs that meet the changing needs of participants and sponsors.

Flexibility is also impeded by the year-by-year age analysis for age discrimination required in the proposed regulations. Under this analysis, many plan amendments are prohibited unless the new plan provision is simply "tacked" onto the prior plan terms without any transition, or the amendment uniformly increases or decreases future benefits provided to all employees. The required year-by-year approach does not allow improvements made in the past -- nor prior preferential treatment of older workers – to be taken into account in the current testing year.

Recommended Modifications

The Coalition recommends the following changes to the proposed regulations to address the concerns we have raised.

? First, we believe that age discrimination for all plans should be tested on the same basis. There should not be a different and more onerous age discrimination rule that applies to only 20 percent of the employer-sponsored plans in existence. A pattern of benefit accruals is either age discriminatory or it is not. The legal status of such accruals should not depend on the plan form in which the accruals are delivered.

Testing for age discrimination in this consistent way can be accomplished by reviewing the formula set forth in the plan document to ensure that the rate of accrual does not decline with age. Such an approach is consistent with legislative intent and traditional methods of determining age discrimination in the pension context.

? In the alternative, the regulations' computational general test could be modified to consider the economic value of the benefit, not the age 65 benefit. Such a test would not consider a plan to be age discriminatory merely because a participant's benefit is adjusted to reflect the time value of money between the accrual of the benefit and the participant's retirement. However, a computational test would need further modifications in order to avoid mis-labeling many common and traditional plan designs and transactions as age discriminatory.

? In that regard, the Coalition recommends adoption of an "accrued-to-date" test (rather than an annual test) for determining accrual rates. Such a test eliminates anomalies in patterns of benefit accrual and provides an appropriate test to determine whether a plan amendment, including a conversion from a traditional plan to hybrid plan, is age discriminatory.

? Finally, we recommend modifications to address two issues that I have not had time to discuss in my testimony today: the problems posed by the proposed regulations for offset designs and post-normal retirement age accruals. Building on the current law for testing offset plans under either the general nondiscrimination rules or the accrual rules, the final regulations should allow plans to test for age discrimination on the basis of the gross benefit, not just the net benefit. In addition, we recommend maintaining the existing rules for benefit delivery to employees who are older than the plan's normal retirement age, particularly in situations where the plan does not suspend benefits or offset for in-service distributions.

Conclusion

With these suggested changes, the government can ensure that participants are protected against age discrimination, but can avoid the extreme disruption to the defined benefit system that would result from the regulations as currently proposed. Such disruption serves the needs of neither participants nor sponsors. At this particularly fragile moment for the defined benefit system, we must ensure rational and consistent age discrimination treatment for pension designs and amendments. The Coalition appreciates the opportunity to contribute to the development of such standards. Thank you for the opportunity to appear. I would be pleased to take your questions.