
Keane White Paper

Retirement Ready

The Pension Protection Act of
2006 and what business and IT
leaders need to know to help
their customers grow their
nest eggs

EXECUTIVE SUMMARY

In August of 2006, congress passed the Pension Protection Act (PPA), which seeks to safeguard workers' pensions and expand opportunities for retirement savings. While the benefits for individuals are clear, the Act will impact retirement services firms as well as every corporation and public agency in America that offers retirement plans to their employees.

From an IT standpoint, the challenges are great: business rules governing how plans are treated will have to be changed to comply with the new regulations. The applications and IT infrastructure behind these rules will have to be modified to create the scalability needed to support an influx of participants. And data management and reporting processes will have to be improved to comply with stricter guidelines.

Yet passage of the Act also presents new business opportunities. Firms will see a rise in the number of plan participants through automatic 401(k) enrollment. And rules that once limited advisory services have been eased. In addition, with passage of the PPA, corporations and plan administrators have an opportunity to introduce their customers to a wide array of products and services.

As businesses focus on modifying processes and rules to comply with the PPA, IT will need to quickly assess its capabilities and redirect energies to enable support for new and modified products, services, information, and reports.

While this white paper does not present a comprehensive list of PPA provisions, its aim is to help business and technology leaders understand the technology implications and show them how to meet the challenge by developing a PPA program designed around four components: (1) optimizing processes, (2) building a scalable applications and data architecture, (3) providing a distinctly sophisticated user experience, and (4) ensuring governance through a cohesive program management office.

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The Pension Protection Act

Analyst estimates indicate that by 2020, nearly 17% of the total US workforce will be 65 or older. In five years, the oldest members of this demographic behemoth will start retiring. Yet their golden years will coincide with a time of growing uncertainty in the ability of pension funds to pay out benefits. It is estimated that single-employer pensions today are under-funded to the extent of nearly \$340 billion. The PBGC (Pension Benefit Guarantee Corporation) is saddled with a total deficit of more than \$23 billion. Furthermore, the expiration of the Pension Funding Equity Act (PFEA) in 2005 (which allowed employers to temporarily lessen their plan contributions) creates questions for sponsors seeking to fund their pension obligations for 2006. In fact, failures of traditional pension plans have been at an all-time high: witness the debacles at US Airways, United Airlines, WorldCom, and Enron.

To enable better funding of pension funds, encourage savings, and bring greater transparency to retirement services, the Pension Protection Act (PPA) was signed into law on August 17, 2006. The PPA is the first comprehensive reform package in the last 30 years (after ERISA in 1974) to completely change the dynamics of the retirement services business in the US.

The PPA has four basic parts: (1) new funding rules for defined benefits (DB) plans designed to prevent underfunding; (2) new rules to strengthen defined contribution (DC) plans, which include allowing firms to offer its employees personalized investment advice and lifting restrictions on automatic enrollment

in 401(k)s and similar vehicles; (3) the extension of savings and tax incentives, by way of making permanent the temporary provisions of EGTRRA (Economic Growth & Tax Relief Reconciliation Act); and (4) new rules requiring enhanced reporting and disclosure.

The Compliance Challenge

Passage of the PPA affects many of the typical retirement plans offered today by employers, such as IRAs, 401(k)s, 403(b)s, and hybrid plans, as well as many educational plans, such as 529 plans (see Figures 1 and 2). PPA changes therefore impact multiple functional areas across the firm (and partner firms), including plan design and setup, plan sponsorship, human resources and payroll, record-keeping, plan administration, investments and asset management, advisory services and compliance, and reporting (see Figure 3).

With the Act affecting so many areas, few professionals in the retirement space can ignore the PPA. Plan sponsors, administrators, advisors, asset managers, and record-keepers therefore need to identify gaps between PPA objectives and the current state of their business and IT processes, systems, and applications. Complying with the PPA will require firms to re-engineer and optimize processes, as well as to design, implement, and test modifications to current applications. Re-engineering and optimizing processes will be even more important for firms moving toward providing Total Retirement Outsourcing (TRO), where there is an added focus on cost containment and fee aggregation. In addition, these firms will have to improve

reporting and enhance their data architecture. Once these important changes have been made, they need to communicate them to their many constituents, including broker channels, plan sponsors, participants, and employees.

As further regulations governing defined contribution (DC) plans emerge, loans processing, distribution calculations, vesting determination, and government report preparation will be affected. Firms must ensure they have the processes in place to meet these new requirements.

The good news is that while the guidelines of the PPA pose a compliance challenge for retirement services

firms, they also present significant new business and growth opportunities.

The Opportunity: More Products, Participants, and Advisory Services

There's no question that the popularity of defined contribution (DC) plans has increased over the last few years. In particular, 401(k) plans have become the choice retirement vehicle over traditional defined benefit (DB) plans. During the last 20 years, 401(k)

Figure 1: Retirement Plans Affected by the PPA

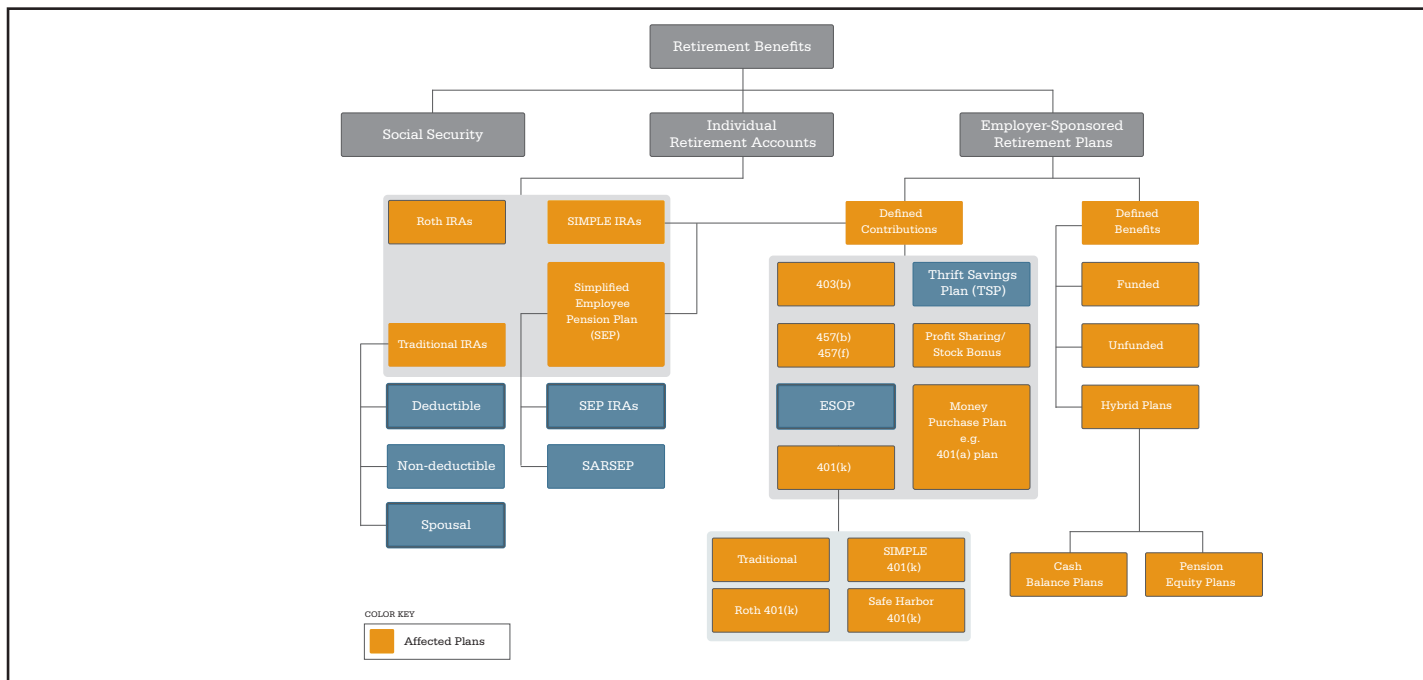
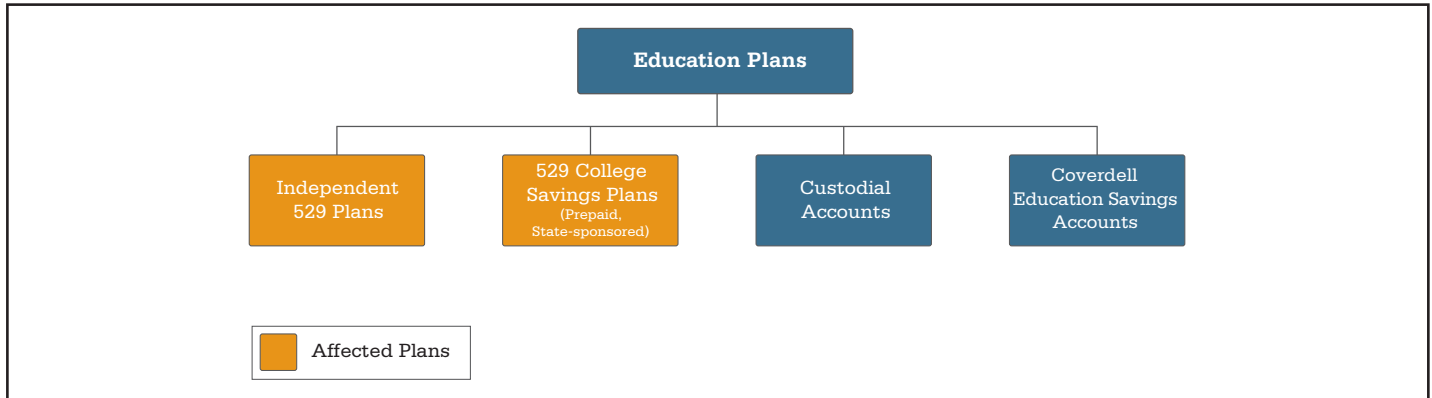


Figure 2: Education Plans Affected by the PPA



assets have grown at a CAGR of 15.21%^{iv}. At the end of 2005, approximately 47 million 401(k) plan participants had accumulated \$2.4 trillion in plan assets — much ahead of assets in any other DC or DB plan^v. While, 401(k) plans have gone through many regulatory and legislative changes since their initial regulation by the IRS (in November 10, 1981), The Pension Protect Act of 2006 aims to revolutionize the retirement services industry and encourage further 401(k) growth. encourage further 401(k) growth.

Automating 401(k) Enrollment

The hefty (900-plus-page) reformThe hefty (900-plus-page) reform package aims to encourage workers to save for retirement through defined contributions. One way it does this is by encouraging plan providers to automatically enroll employees in the company's 401(k) plans. While this feature is not new to the industry (approximately 16.9% of plans in 2005 are already using automatic enrollment^{vi}), the PPA has given it new impetus. The PPA's automatic enrollment enables companies to set the default contribution at a certain percentage, say three percent of the employee's pay, and allows the participant to opt out.

The PPA also protects employers from state payroll withholding laws that would otherwise prevent them from instituting automatic enrollment. Under the law, an employer can automatically enroll employees in a 401(k) plan and set minimum contribution rates without their approval. This minimum applies when employees do not elect to make changes to their plans. Employees can change the employer's election or opt out of the plan within 90 days for a penalty-free return of automatic contributions. Although the Department of Labor is currently working on defining the guidelines for default investment levels, investment advisors will increasingly influence the choice of plans for participants.

There will also be clear demand for 401(k) plans offering lifecycle funds and an increase in the number of investment options. Sponsors and plan administrators will therefore need to collaborate to provide new or modified products and services.

Although the automatic enrollment provision will not go into effect until January 2008, many plan providers have already started offering automated 401(k) enrollment. While most firms have taken a

Band- Aid approach to enhancing their process and technology architectures (applying application fixes as they need them), firms that take a broad view of their architecture will gain the flexibility they need to support new products, services, and participants while demonstrating compliance cost-effectively.

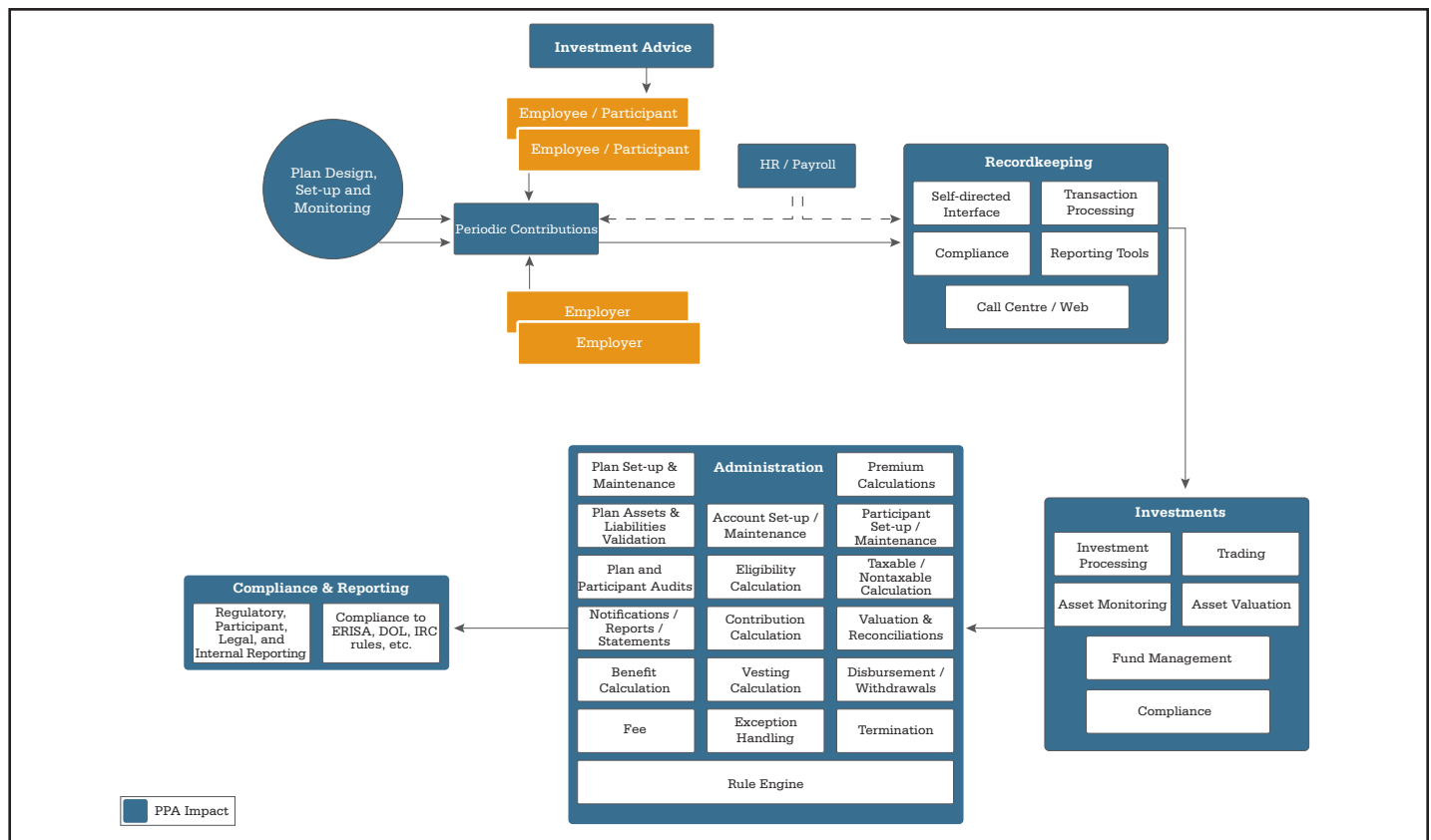
Apart from legislative support, an important reason for the phenomenal growth in participation rates of the 401(k) has been the plan's design aimed at meeting workers' needs, such as allowing employer

contribution and offering a variety of investment options. However, the plan's continued success will depend on its flexibility and features, such as loan provisions, employers' matching contributions, vesting options, investment options, and model portfolios.

Enhanced Advisory Services

Retirement services firms expect that plan participation will double in the next five years due to passage of the PPA. In addition, as the Baby Boom

Figure 3: Functional Plans Affected by the PPA



generation retires, the assets eligible for wealth transfer will amount to a huge \$19.9 trillion, after fees and taxes are assessed. This presents a tremendous opportunity for firms to not only grow their participant base, but also present them with a diversity of retirement product choices. To that end, the PPA lifts existing restrictions that previously prevented retirement services firms from providing such services. However, less than 20% of banking customers value the online advice given by their financial institutions, according to a Keane study that surveyed 1,800 financial services consumers in the US, UK, and Canada. This means that retirement services firms will need to bring a new level of scale to their advisory functions in order to support an ever-expanding menu of new products and services for a growing participant base.

Online advisory services will need to be designed around customer self-service, must be significantly easier to use than the ones currently offered, and should be targeted to their specific needs. In fact, only a little more than 50% of banking customers Keane surveyed strongly agree that their primary financial institution's site is targeted to their needs. Customers today expect tailored advice — they buy products and services that are designed to match their life-events, rather than by perusing lists of standard offerings. Companies that create a personal and useful online experience will tap this growing market. For example, one retirement services firm has built an interactive Web site, using rich Internet applications, to help customers plan for retirement. A friendly voice leads users through dynamic screens that ask five questions primarily about their savings habits. In just a few minutes, users are provided with a personalized chart that shows how far along they are in meeting their retirement goals. Then, by adjusting parameters,

such as increasing the amount of monthly savings, users can immediately see changes in these projections. Users are then given the option of selecting a variety of retirement products or creating a more detailed financial plan. To compete with these leading firms, IT needs to prepare itself to cater to this combination of customer sophistication and rapid scalability new products and services for a growing participant base.

The IT Challenge

As product development managers, strategy groups, and actuaries comb through the legislation to modify and redesign existing retirement plans, and design the products and services that will allow customers and sponsors to avail of new savings incentives, IT needs to proactively assess its capability to deliver on the changes. Aligning IT investments with business goals will quickly assume greater significance as PPA guidelines evolve. For IT, the mandate is clear: its ability to support key DB and DC processes must become more flexible and scalable.

Far too many retirement services firms today rely on manual, paper-based processes and nonstandardized handoffs between administration, record-keeping, investments, and compliance systems. The lack of process automation in sponsor, administration, and asset management firms is a continuous challenge to efficiency and will be a serious impediment to complying with, and taking advantage of, PPA guidelines. Therefore, IT must develop a program to address the strategic and tactical challenges posed by the PPA.

Building a PPA Program

An enterprise-wide strategic PPA program has four key components: (1) optimizing processes, (2) building a scalable applications and data architecture, (3) providing a distinctly sophisticated user experience, and (4) ensuring governance through a cohesive program management office.

1. Optimizing processes

An effective PPA program begins by improving business and IT alignment. To accomplish this, there must be a fundamental understanding of how systems are being used to support existing processes and a focus on improving operational efficiency. Retirement services firms need to first assess their current defined benefits and contributions processes and change process steps and business rules to comply

with PPA rule changes. For example, plan providers must identify redundancies among business processes handling DB and DC plans — and 401(K), 403(b), and IRA enrollment — and work toward optimizing these, in addition to clarifying related roles and functions. Process hand-offs need to be identified and functions, such as changing contribution levels, need to be automated as much as possible, eliminating manual paper-based steps.

2. Building a scalable applications and data architecture

Building or redesigning applications in order to cater to the needs of the PPA program requires a careful assessment of the existing IT environment. IT leaders need to assess the supporting technology architecture for its ability to support a growing participant base without compromising performance. For example, asset managers will need immediate IT scalability to address the investment needs of a burgeoning participant base.

Figure 4: Building a PPA Framework



Pennywise - To win at compliance, firms must look carefully at their business rules

To comply with new PPA regulations, firms will need to modify the business rules governing a host of applications. The following is not a comprehensive list of rule changes mandated by the PPA, but rather highlights several areas for consideration:

a) To enable the extension of savings provisions, rules in applications supporting DB and DC plans will need to be modified to make permanent the higher contribution limits set for 401(k), 403(b), and IRA plans. Restrictions pertaining to the movement of assets (rollovers) between traditional IRAs, 403(b), and 457(b) plans have been relaxed. And rules will need to reflect salary and catch-up contribution limits set in 2006 that have now become permanent, such as:

- » IRA contribution limit of \$4,000
- » DB plan annual benefit limit of \$175,000
- » 401k plan limit of \$15,000
- » 457 plan limit of \$15,000
- » Simple IRA limit of \$10,000
- » Annual DB limit of \$175,000
- » Annual DC limit of \$44,000

b) In applications that govern funding, firms must modify funding thresholds. The new law requires most plans to become 100% funded over a seven-year period. (The current funding target is 90% of a plan's liability.) Plans that are not fully funded at the start of 2008 have an interim target of 92% in 2008, 94% in 2009, and 96% in 2010. These contribution changes will help plans meet stricter funding rules, while plans "at risk" will require enhanced reporting and analytics capability.

c) The passage of the PPA will also change over 20 retirement tax-savings benefits and introduce new rules governing specific charitable donations. For example, retirees can give up to \$100,000 directly from an IRA to a charitable organization without paying income tax. Also, payments received or accrued by certain exempt organizations from taxable controlled subsidiaries will not be treated as unrelated business taxable income. In addition to implementing these rules changes, firms must enhance reporting and analytics to account for the tighter

control of exempt organizations. There is also a need for organizations to enhance their CRM capabilities not only to demonstrate compliance, but to better target their customers with appropriate new products.

d) To account for new rules dealing with donor-administered funds, plan providers must modify the design of business rules within applications handling charitable contributions. Specifically, the PPA has redefined gross investment income and set stricter rules for donations of cash, clothing, household, and other items. For example, non-itemizers will neither be able to deduct their charitable contributions nor deduct used clothing or household items unless they are in "good" condition. And deductions will not be allowed for cash, check, or other monetary contributions without a bank record or communication from the charity. Also, distributions up to \$100,000 from IRA and Roth IRA are excluded from gross income.

Furthermore, the PPA now allows blood banks and blood collector organizations to be exempt from certain excise taxes, fines, and penalties; while it doubles the excise tax for certain activities by charities, social welfare organizations, and private foundations, and sets new penalties on appraisers who provide bogus appraisals.

e) The PPA also introduces new savings vehicles, such as hybrid DB plans. (Such plans have DB and DC features but the investment risk and reward are held by the employer.) Firms must modify the business rules in existing applications to support these new products and enable better governance of cash balance and hybrid DB plans.

With passage of the PPA, the law now:

- » Permits certain small employers to create linked 401k and DB plans
- » Makes flexible the rules allowing sponsors to provide investment advice to participants
- » Limits an employer's ability to mandate a plan's investment in employer stock
- » Introduces a new formula for converting traditional plans to hybrid plans

- » Alters vesting schedules and interest credit rates to comply with age discrimination rule
- » Changes lump-sum distribution requirements, so that they may be based solely on the participant's projected account balance
- » Ensures that the interest credit or equivalent amount for any plan year does not exceed the market rate of return. In addition, firms must make sure that the plan follows regulations governing the calculation of market rate of return set by the Treasury department.
- » Makes permanent the Roth feature

f) Data quality and governance will be another critical aspect of a PPA program, which will enable more robust business intelligence and reporting. First, firms will have to assess existing data management processes to improve the quality of campaign and customer relationship management data. Firms must also improve the quality of operational and business intelligence data, functionality, and access.

To comply with stricter disclosure and reporting rules, firms must enhance auditing, monitoring, and compliance controls, in addition to data quality and reporting capability. Specifically, the PPA will require the electronic display of:

- » Form 5500 annual report
- » Annual funding notice
- » Benefit statements to participants
- » Notice of termination
- » Certification from actuary regarding plan status
- » PBGC 4010 filing
- » Benchmark standards and procedures

New reports will also need to be developed for charitable organizations. These include those organizations that must report on exempt entities and provide receipts to taxpayers.

Firms need to evolve their IT architecture to keep pace with new guidelines as they are released. To create functionality that is flexible and easy to maintain, and that can change as business priorities do, firms should adopt a services-oriented architecture (SOA).

Application functionality needs to be designed as discrete, loosely-coupled, shared services that can be assembled to create higher-level functions. For example, designing the change of address or deduction percentage function as a shared service enables the data to be reflected across applications. These services will be designed to be reusable, will be easier to maintain, and will reduce application development time and cost.

In addition to evolving to a servicesbased architecture, firms will haveto extract and externalize business rules and place them in a business rules engine (BRE), where possible. Business logic and rules that are centralized in a BRE are easier to modify than those that have not been decoupled from data and end-user interfaces. They will also enable more robust reporting related to plan administration, recordkeeping, and employee communication, as required by the PPA. Employing technology innovation in conjunction with a BRE, such as using business process management (BPM) tools to automate workflow and processes, will increase architectural agility.

In addition to being externalized, where possible, business rules will need to be modified to comply with PPA regulations. See sidebar “Pennywise” for an overview of several critical areas that will require modification.

3. Providing a distinctly sophisticated user experience

Because the PPA allows providers to offer participants more investment options, it will naturally follow that

participants will demand greater levels of online self-service. To meet user demand, a critical part of a provider’s PPA program will be its renewed focus on the usability of applications and streamlined access to information. Online enrollment will need to be simplified and made user-friendly, and firms will need to enhance the usability and usefulness of Web-based retirement planning advice.

To comply with the PPA, and to make sure participants do not opt out of the default enrollment, firms must offer participants tools that ease the investment selection process. Applications will need to provide more usable and interactive enduser interfaces using rich Internet technologies (RIA), such as Flex and Ajax, that can provide a dynamic user experience, where users will be led through product choices based on their demographic situation and life events rather than presented with a static list of products and services.

4. Ensuring governance through a cohesive program management office

Even a well-planned PPA program cannot succeed without a strong execution engine. A Program Management Office (PMO) centralizesthe management, oversight, and coordination of large-scale programs that cross multiple functional organizations (and geographies), thereby mitigating risk and improving communication. A PMO not only formalizes management and reporting activities, but also uses quality, performance, and business metrics to see to it that activities are performed effectively and efficiently. In addition, by making use of efficiencies ofscale, standardized processes, and continuous improvement activities, the PMO can often significantly increase productivity.

Strong program management and governance mechanisms will ensure appropriate budgetary and

resource allocation and will make sure that project objectives are aligned with the business strategy. The PMO also provides a flexible level of control necessary to ensure that a missioncritical program completes on time and within budget while achieving business objectives.

The complexities of managing a series of concurrent and interrelated projects across many functional boundaries area challenge to traditional project management capabilities. Because of this, many firms choose to partner with an IT services provider that has a solid understanding of PMO process and methodologies, access to skilled program and project managers, and experience in managing large-scale, cross-functional, and business-critical initiatives.

Making It Work

Implementing a formalized PPA program can help align IT investments with business priorities and PPA directives. To succeed, business and IT need to partner to not only apply rule changes to core applications, but create a strategic plan to evolve their business process and technology architecture. A PPA program will provide the guidelines for effective business analysis and project management of process and business rule changes. In addition, it will help firms build an architecture that will enhance data and reporting applications and employ new technologies (such as SOA and RIA) to improve the usability and scalability of the current infrastructure. In addition, a program that identifies opportunities for outsourcing offshoring application development and maintenance may allow for further cost savings.

To build a PPA program, an enterprise should begin with a process and IT assessment that can deliver a roadmap of initiatives, prioritized by business objectives and the PPA timeline.

Selecting a Partner

When undergoing such wide-scale conversions as required by the PPA, many firms choose to partner with an IT services provider. A third party can view processes critically and prevent conflicts of interests. Because an effective PPA program requires high-level expertise with regard to retirement services systems and processes, organizations must first evaluate the IT services providers' capabilities. Consider the following:

- » Retirement services expertise: Does the IT services provider have a rich portfolio of retirement services clients? Does it have an understanding of your IT systems and business processes?
- » Large-scale compliance initiatives: Has the IT services provider successfully implemented compliance initiatives of similar scope and complexity?
- » IT architecture expertise: Does the company have the necessary technology know-how with SOA, RIA, and business intelligence optimization? Can it show success with BPM and BRE tool sets?
- » Proven methodology: Does the IT services partner have a proven framework that will identify compliance gaps and implement an IT roadmap that aligns with business and PPA priorities?

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- » Program management: Does the IT services provider manage projects through an onsite program manager, providing a single point of accountability for all program and project efforts no matter where they are executed?
 - » Flexible delivery options: Does the partner firm offer a flexible range of resources, locations, and cost structures that allow you to balance cost-effectiveness with delivery requirements?
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Conclusion

Companies in the retirement services space must take steps to comply with the regulations mandated by the PPA. However, it will be those companies that take advantage of the business opportunities provided by the new legislation that will leapfrog the competition. Establishing a PPA program can provide firms with a strategy that will increase revenue growth through enhanced products, services, and processes, and give them the IT scalability they'll need to support increased volume and add new functionality as required.
