Issue Brief

The United Kingdom's New Retirement Savings Program

By John A. Turner and Jennifer Erin Brown

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ABOUT THE AUTHORS

John A. Turner is Director of the Pension Policy Center. He has published numerous papers on pension policy issues. His papers have received awards from the Society of Actuaries, the International Actuarial Association, the Journal of Risk and Insurance, AARP and the Department of Labor. Two of his books have been translated into Japanese, and three of his books have been selected by the Society of Actuaries as required reading for actuarial examinations. He is a founding member of the European Network for Research on Supplementary Pensions. He received a Ph.D. in Economics from the University of Chicago.

Jennifer Erin Brown is the Manager of Research for the National Institute on Retirement Security (NIRS). She joined NIRS in October 2015 and conducts research and analysis on pension and retirement issues. She is also a Tax Policy fellow at the American University Kogod School of Business where she serves as an Adjunct Professor. Previously, she served as an Employee Benefits Law Specialist at the U.S. Department of Labor's Employee Benefit Security Administration where she worked on issues related to corporate transactions, financial products, and the Affordable Care Act. She holds an LL.M. in Taxation and a Certificate in Employee Benefits Law from the Georgetown University Law Center, a J.D. from the American University Washington College of Law, an M.S. in Law & Society from the American University School of Public Affairs, and a B.A. in Philosophy and Criminology from the University of Florida.

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ABOUT NIRS

The National Institute on Retirement Security is a non-profit research institute established to contribute to informed policy making by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole. NIRS works to fulfill this mission through research, education, and outreach programs that are national in scope.

I. INTRODUCTION

In the United States, nearly 40 million – or 45 percent – of working-age households do not own a retirement account, such as a 401(k) plan or an Individual Retirement Account (IRA).[1] This shortfall in retirement accounts means that the typical working household has virtually no retirement savings, and more than three out of five near-retirement households have less than one times their income saved for retirement.[2]

A similar deficit in retirement planning exists in the United Kingdom and is now being addressed with a bold, new retirement savings program. This program requires all employers to automatically enroll their employees in retirement accounts. Employers are also required to contribute to the plan if an employee participates in it; however, individuals have the option to opt out. This new program is being phased in and should be fully implemented by 2018.

The program has succeeded in expanding coverage in the U.K. by six million workers, and a total increase in coverage of nine million workers is expected when the program is fully implemented.

Table 1: **Demographic trends in the United States and United Kingdom**

Trend	Year	US	UK
Birth Rates (per 1000)	2005	14	11
	2025	13	11
Life Expectancy	2005	77	79
	2025	79	81
Median Age	2005	37	38
	2025	38	41

Source: D. Farrell et al., 2005, " The coming demographic deficit: How aging populations will reduce global savings," McKinsey Global Institute, http://www.mckinsey.com/industries/financial-services/our-insights/the-coming-demographic-deficit.

Across the globe, developed nations face a demographic shift to an older population which will reduce economic growth. As the aging population increases demands on social safety net programs that help the elderly, relatively fewer working-age citizens will engage in activity to boost economic output. The U.S. and the U.K. display similar demographic trends as seen in **Table 1**.

Studies of the projected economic impact of aging predict that the growth of household wealth will slow and suggest that households and goverments increase individual savings to counter the coming wealth shortfall.[3]

The U.S. has made numerous policy innovations over the past several decades to expand retirement coverage for the American workforce. The theory supporting these changes is that employees will participate in a retirement plan if doing so is sufficiently convenient and attractive for them. In the late 1970's, 401(k) plans emerged initially as supplemental savings accounts for employees and over time they have evolved into the primary retirement plan for employees of American companies. One of the most recent innovations in this vein is the myRA account established by the U.S. Treasury Department which serves as an accessable product for low-income workers.[4]

Despite these policy innovations, pension coverage rates have not shifted and have remained around 50 percent or less for decades in the U.S. In addition to lack of access to an employer plan, one of the explanations for low coverage is that in a typical 401(k) plan, less than 70 percent of eligible workers participate.[5] Also, coverage is low among part-time workers and full-time workers in small firms.

The typical working American household has minimal retirement savings, as the median amount for all households is only $2,500, and for near-retirement households the amount is only $14,500. Furthermore, 62 percent of working households between the ages of 55 and 64 have retirement savings that are less than their household's annual income – an amount far below what they will need to maintain their standard of living in retirement.[6]

A similar situation exists in the U.K., where half of households have nearly no savings or investments.[7] On average, private sources of retirement income account for 49 percent of income.[8] Including both the public and private sectors, 62 percent of pensioners receive an occupational pension and 19 percent of pensioners receive a personal pension, similar to an IRA.[9]

Pension coverage can be expanded with varying degrees of government intervention through incentives, nudges, and mandates. In the U.S., retirement savings have long received tax-favored treatment. The essence of the tax subsidy to retirement savings plans is that investment income is not taxed, so that investments in retirement savings plans earn a before-tax rate of return, while investments not in retirement savings plans generally earn an after-tax rate of return. With the advent and growth of 401(k) plans, many employers provide matching contributions which further augment the incentive from the deferral of tax for employees who participate. More recently, employers have been permitted to nudge workers to save by auto enrolling them in retirement plans while allowing workers the choice to opt-out. The next level of expanding retirement coverage involves providing every employee an opportunity to save in a retirement account directly through payroll.

The U.K. has implemented the stronger incentive of auto enrollment. In 2001, the U.K. required all employers with five or more employees to offer pension plans to their employees, but employers were neither required to contribute to those plans nor were employees automatically enrolled in a plan. Going a step further, starting in October 2012, the U.K. launched a new retirement savings program that is designed to expand pension coverage while maintaining a minimum level of contributions. The program is being phased in, and by February 2018 all employers will be required to offer retirement plans meeting minimum requirements, contribute to those plans, and automatically enroll their employees into plans. All employers who choose to not sponsor their own pension plan that meets the minimum requirements concerning employer and employee contributions are required to enroll their employees in the National Employment Savings Trust (NEST), which is a government-sponsored plan.

Automatic enrollment is viewed as an attempt to transform the culture of long-term savings in the U.K. Once enrolled in either an employer-sponsored plan or NEST, employees have the option to withdraw from the plan. As of 2016, more than six million workers have been automatically enrolled and by 2018, more than nine million people are expected to be enrolled in a pension plan or will be saving more due to automatic enrollment.[10]

This paper, the first detailed analysis for an American audience reporting on the progress of the U.K.'s retirement policy initiative, starts by discussing the goals of the new savings program. It then describes the phase in of the program, the requirement for auto enrollment, and the required level of contributions. Next, the paper discusses the NEST program and describes its various features with a focus on its default investment option. The paper concludes with comments about the phase in of higher contribution rates and how that may affect future opt out rates.

II. THE U.K. RETIREMENT SAVINGS PROGRAM

U.K. Retirement Savings Program Goals

Since the mid-1970s, the U.K. has enacted numerous reforms to its State Pension program, which is comparable to the U.S. Social Security system. The reforms have resulted in a complex retirement system where workers of different ages are in different programs. Until April 2016, the U.K.'s State Pension programs included a flat rate means-tested benefit of about $8,000, plus an earnings-related State Pension benefit. Since April 2016, the U.K. has had a single, flat rate (not earnings-related) program.[11]

Historically, the level of benefits in the U.K.'s State Pension program has been low, with many people receiving means-tested benefits. About 50 percent of pensioners qualify for these benefits.[12] This development is a concern because means-tested benefits are administratively expensive to provide and have a stigma for many people. OECD figures for gross replacement rates (replacement of gross earnings, not subtracting taxes) for a worker with average earnings are 21.6 percent for the U.K., compared to 35.2 percent for the U.S.[13]

Starting in 2001, the U.K. required all employers with five or more employees to offer a pension plan, called a stakeholder's pension. The U.K. has a system of government-provided health care, and thus there appears to be an acceptance in the U.K. of government mandates relating to employee benefits. This program did not include auto enrollment and has been unsuccessful, resulting in many employer-sponsored plans with no participants.[14] The convenience to employees of an employer-provided plan was not a sufficient incentive to have an effect on employee participation.

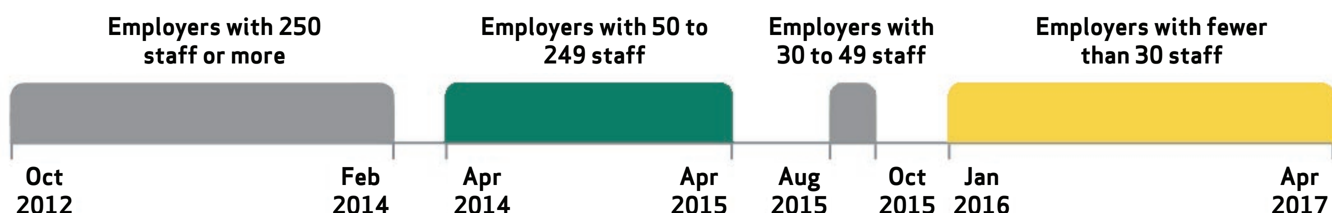
This new program goes a step further toward the goal of expanding pension coverage by taking a "nudge" approach, as it requires that employees be automatically enrolled in the plan, but with an opt out provision.

Employers are required to offer a retirement plan to their employees – either their own plan or one offered through a third-party pension provider, such as an insurance company, or through NEST. Employers already offering a plan must review its provisions to ensure that minimum requirements are met. Employees are automatically enrolled in a pension plan within three months of becoming eligible, but they can opt out. Their contribution rate is automatically set by the law, but they can choose to contribute a higher amount. Their investments are automatically determined by a default, but they can choose different investments. They are required to leave the assets in the account until retirement with limited options for early access.

The Phase In

As shown in **Figure 1**, automatic enrollment is being phased in over a span of six years. Starting in 2012, according to the size of the employer – employers with more than 120,000 employees were the first to implement the program. In the third year – 2015 - 45,000 employers began offering plans to their employees. However, at the end of 2015, only three percent of all employers were included, because most

Figure 1: **NEST Phase-In, by Size of Employer, from 2012 to 2017**



Source: NEST, 2016, "Employers' Guide to Auto Enrolment and NEST." https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/Employers-guide-to-automatic-enrolment,PDF.pdf

employers are small and will be the last to adopt the program. As of 2015, of the employers not yet phased into the system, 83 percent did not already provide a pension plan.[15] Each month during 2016, 45,000 employers will be brought into the system. The phase-in of automatic enrollment will end in February 2018, when all new employers created since October 2012 will be required to participate.[16]

Service Providers

The capacity in the benefits industry to enroll new pension plans is about 2,100 a month.[17] Thus, many small employers will be forced to enroll in the government plan NEST, even if that is not their first choice, because the industry will not have the capacity to enroll them.

Research indicates that 74 percent of small and micro-employers will use an outside expert to help with auto enrollment. Those experts generally are independent financial advisers, payroll professionals or accountants, with accountants being the most utilized service provider.[18]

Table 2: **Types of Plans Used for Automatic Enrollment, 2015**

Plan type	Percent of workers automatically enrolled
Defined benefit	6%
Hybrid	5%
Defined contribution	88%
Trust	53%
Contract	35%
Unknown	1%
Total	100%

Source: The Pensions Regulator, 2015, "Automatic Enrolment—Commentary and Analysis: April 2014 to March 2015." http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-commentary-analysis-2015.pdf

Automatic Enrollment Requirements

The automatic enrollment requirement applies to workers age 22 and older earning more than a minimum amount of £10,000 ($12,000) annually from their employer. Workers who opt out are automatically reenrolled every three years. The maximum age for workers for whom the participation requirement applies is 65 for men, while the maximum of 65 for women is being phased in. The maximum age for both men and women is set to rise in the future to be in line with the age at which workers can access their State Pension benefits. Employees outside those age ranges but in the age range 16 to 75 can ask to be enrolled. Self-employed persons are not required to be enrolled, but may do so.

Most workers eligible for auto enrollment are men, as only 36 percent are women. This is due to the fact that the maximum age for mandatory enrollment is lower for women than it is for men, and that women earn less than the minimum earnings limit. Even though many women earn more than the mandatory minimum for auto enrollment across multiple jobs, their earnings from an individual job does not exceed the minimum amount required for automatic enrollment.[19]

A relatively high percentage of employees working for small employers do not meet the minimum earnings requirement for auto enrollment. Among employees meeting the age requirements for auto enrollment and working for employers with one to four employees, 42 percent do not meet the minimum earnings requirement.[20]

Types of Plans Used

Most of the plans used for automatic enrollment (86 percent) are defined contribution plans as shown in **Table 2**. The majority of automatically enrolled workers (53 percent) are in trust-based plans.

Opting Out

Eligible workers must be auto enrolled within three months of becoming eligible, but can then opt-out at any time. The U.K. government hopes that the inertia will keep workers in the plan. The initial results suggest that the program has been successful in retaining participants due to automatic enrollment. One study finds the overall opt-out rate was

12 percent of auto enrolled participants. Most individual employers had five to 15 percent of workers who opted out after being automatically enrolled. The percentage opting out so far appears to be consistent across different sized firms, but automatic enrollment has not been extended to the smallest firms, where opt-out rates are expected to be higher because they have more lower-income workers.[21]

Opt-out rates vary considerably by age, with 23 percent of participants over the age of 50 choosing to opt-out, versus seven percent of those under the age of 30, and nine percent of those ages 30 to 49.[22] A more recent study found similar opt-out rates of 28 percent for those age 60 or older, compared to five percent for those younger than age 30.[23] Part-time workers are eight percentage points more likely to opt-out than full-time workers – 18 percent opt-out for part-time versus ten percent for full-time. Women were more likely to opt-out than men (14 percent versus 12 percent) — but that may be because they are more likely to work part-time.[24]

The main reasons for opting out include not being able to afford contributions (generally younger workers), feeling like they already had adequate retirement savings (usually older workers), being close to retirement (older workers), and thinking the employer contribution rate was too low (middle aged and older workers with middle income or higher). Opt-out rates are higher for workers age 50 and older than younger workers, though this pattern presumably will change after the initial period of auto enrollment as more workers will enter that age range already enrolled in a plan.[25] Affordability was a reason given by 49 percent of lower-income workers who opted out. In 2014, 16 percent who opted out said they did so because of lack of trust in pension providers, down from 27 percent in 2013. And 22 percent of individuals opted out in 2014 because they believed that there were better ways of saving for retirement.[26]

More recent data shows a small reduction in the opt-out rate overall to ten percent.[27] Workers who opt-out, but who still participate in the labor force will be automatically re-enrolled in three years. While predicting future behavior is difficult and highly uncertain, 41 percent of those who opted out in 2014 said they would definitely or probably stay in the system when automatically re-enrolled in three years.[28] Additionally, a lack of understanding about pensions may play an underlying role in workers not enrolling in pensions on their own and in the decisions of those who opt out. Only 32 percent of all workers said that they understood pensions. Perhaps as a result, only 15 percent said that pensions are the best way to save for retirement. Only 13 percent of people said that they know enough about pensions to decide with confidence how much to save.[29]

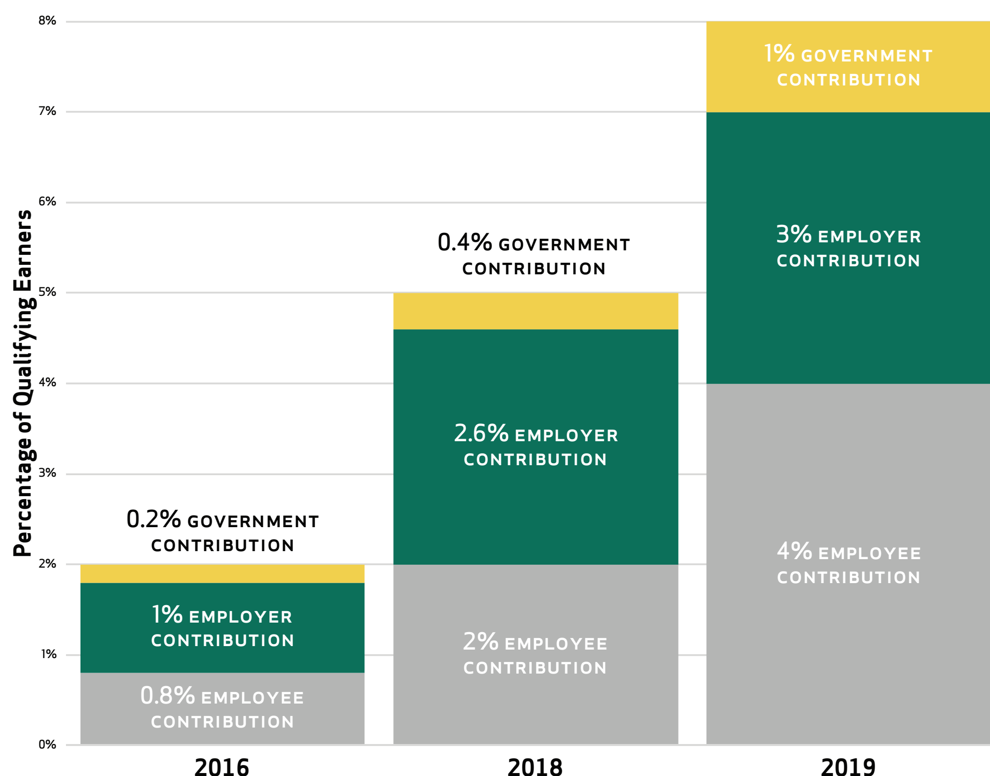
The opt-out rate will likely be higher in the future because the minimum contribution rate is set to increase substantially as the program is being phased in, and because the requirement for auto enrollment is being extended to smaller firms with generally lower-income workers.

Contributions

In the new system, mandatory contributions to a defined contribution plan are made by employers, employees, and the government. Initial contributions for employees total two percent of pay in 2016 and, when fully phased in by 2019, total retirement contributions for an employee from all three sources will equal eight percent of pay as shown in **Figure 2**. Pay for this purpose includes wages and salary, commissions, bonuses and over-time. The employer can choose to exclude bonuses and over-time from the pay used for calculating pension contributions. Contributions are not made on the first £5,824 ($6,990) of pay and contributions stop when pay execeeds £43,000 ($51,600) for the 2016-2017 tax year, which began on April 6, 2016. Thus, the contribution requirement applies to at most £37,176 ($44,610) of pay and is relatively modest.

The minimum required contribution rate is being phased in over time. In 2016, it is a total of two percent, of which 0.8 percent is contributed by the employee. In April 2018, the minimum rises to five percent, of which two percent is contributed by the employee. In April 2019, the minimum is scheduled to rise to eight percent, of which four percent is contributed by the employee, three percent is contributed by employers, and one percent by the government. Employers currently offering defined contribution plans where they contribute less than three percent of pay will be required to increase their contribution rate to three percent. These requirements apply to all plans, so that new plans started after the phase in period will start at the contribution rate required

Figure 2: **Phase-In of Required Contribution Rates as a Percent of Pay**



Source: U.K. Government, 2016, "Workplace Pensions." https://www.gov.uk/workplace-pensions/what-you-your-employer-and-the-government-pay

for all plans. No further increases in minimum contribution rates are scheduled. Both the employee and employer are permitted to contribute more than the minimum.

One of the unknowns in the development of auto enrollment is the effect of the increase in the contribution rate on workers opting out. The increase in employee contribution rates will likely increase opt out rates, but the magnitude of that effect is unknown. The annual limit on contributions increases in the start up years but, by April 2017, it is scheduled to end so that there will be no limit on the amount workers can contribute. For the 2016-2017 U.K. tax year the maximum annual contribution is £4,900 ($5,880). In April 2017, the maximum will be eliminated. Each year the government will review the lower annual limit.

The U.K. government has rules so that defined benefit pension plans meeting specified requirements will also qualify. However, few active private sector defined benefit plans remain in the U.K.

Benefit Payments

The U.K. has a maximum on pension accumulations for the 2016-2017 tax year of £1,000,000, which will be indexed for inflation starting in 2018. Any amount over the lifetime limit that is taken as a lump sum is taxed at 55 percent, which is a penalty tax rate. In the U.S., annual contributions to retirement accounts have caps for both employers and total contributions, but there currently is no maximum on the amount that can be accumulated in tax-preferred pensions. However, the Obama Administration proposed setting a limit so as to restrict the amount of tax subsidies received by people with large pension accounts.

Spousal consent is not required for payouts to retirees. Spouses merely have to be notified that they will not receive widow or widower benefits if the retiree has not chosen joint and survivor protections. Spouses have greater protection in the U.S., where they must agree to a payout from an employer-sponsored plan if the payout takes a form other than a joint-and-survivor pension if the plan offers annuities. Spousal protection does not apply to most 401(k) plans.

One of the criticisms of these policy reforms is that the ultimate contribution rate of eight percent of pay will be insufficient to finance adequate benefits in retirement and that a higher contribution rate will be needed. It may be that in the future the contribution rate will be raised in recognition of this concern. It also may be that a higher ultimate contribution rate was not set initially out of recognition that it would be easier to pass the reform with the lower rates that are set in the current law.

Fees

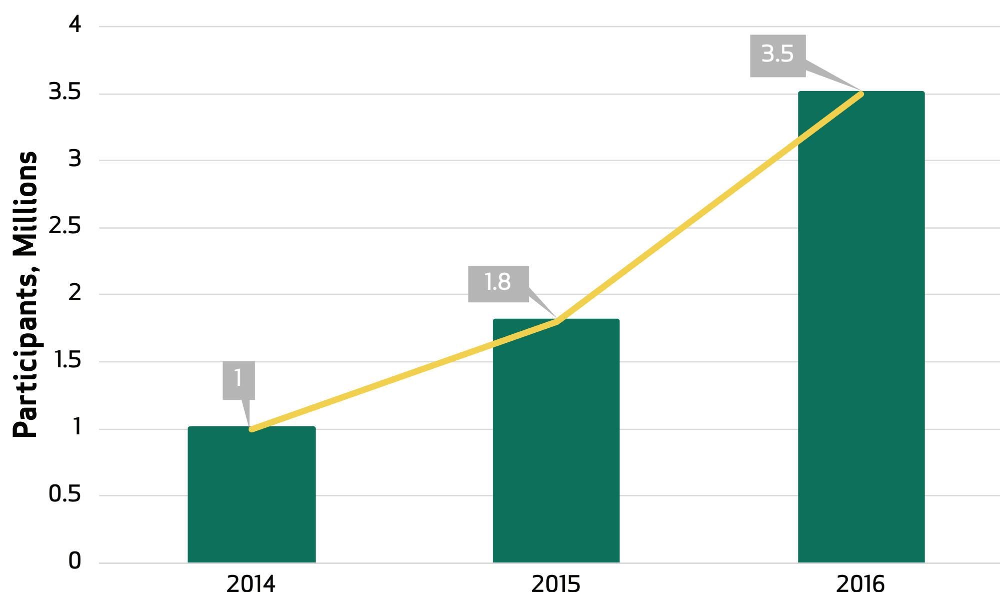
The U.K. government has placed a cap on fees charged to workers on default investment funds of 0.75 percent (75 basis points). In addition, the government has banned active member discounts in plans used for automatic enrollment, where participants in a plan who had changed employers were charged higher fees than active participants in the plan.[31]

An alternative approach, taken in the U.S., is not to set a maximum fee level, but to require employers to offer options with reasonable fees and require providers to clearly disclose fees, so participants can choose to select low-fee providers over those with higher fees. If the U.S. were to instead establish a cap on fees, it is likely that most of the fees would tend to cluster around the cap – creating little incentive to establish lower fees.

A problem with the auto enrollment system is a lack of transparency about fees. For example, NOW – one of the largest providers of pensions through auto enrollment, does not provide information about fees on its website.[32] The same is true for People's Pension, another large provider.[33]

Companies must choose a qualifying pension fund, meaning one to which the required minimum contributions are made, to receive the contributions made to auto enrollment pensions. The system does not contain a default option for employers—they must make a choice. One of the options for employers is a non-profit, multi-employer pension fund established by the government in 2010 called the National Employment Savings

Figure 3: **NEST Participants Have Grown Over Time**



Source: NEST

Major Providers in the U.K. Marketplace

In addition to NEST, the two largest retirement plan providers in the U.K., including NOW and People's Pension, both charge fees to employers. NOW is a U.K. subsidiary of the Danish national pension fund ATP, the largest pension fund in Denmark. NOW was established in the U.K. to help companies comply with the auto enrollment requirement. It provides a pension plan for employers seeking to deal with auto enrollment. To keep costs down, NOW offers employees no choice as to investments. It maintains two investment funds—one for the main part of the worker's working career, called the Diversified Growth Fund, and a second fund that workers are gradually shifted into as retirement approaches, called the Retirement Countdown Fund.

The People's Pension is provided by B&CE, which is a nonprofit financial services organization. It offers pension participants three fund choices - balanced, adventurous, and conservative. The default is the balanced fund. Whichever fund the participant is in, the participant's investments automatically begin switching into a more conservative fund when the participant is fifteen years from retirement.

Trust (NEST). In early policy discussions, some argued that everyone should be auto enrolled into NEST, but that policy was rejected.[34]

The justification for a government-sponsored pension provider is the failure of the market to provide pension plans to some workers. In terms of the demand for pensions by workers and the supply of pensions by pension providers, this is a supply-side market failure. In particular, many small employers with low-paid employees are not attractive to existing for-profit pension providers.[35] For this reason, NEST's focus is smaller employers and low-to-medium income workers. NEST is required to provide a pension to any employer enrolling, even if the cost of administering the pension is greater than the fees NEST receives.

Participants

With the requirement of auto enrollment being extended to more employers, the number of participants in NEST is growing rapidly. As of April 2014, less than two years after starting, NEST had more than one million participants,[36] and that number rose to 1.8 million in 2015[37] and 2.9 million members as of March 2016.[38] In fact, NEST had more than 3.5 million members as of September 2016, as displayed in **Figure 3**.[39]

NEST plays a major role in auto enrollment, as roughly half of auto enrolled workers are participating in NEST. More than 185,000 employers have signed up with NEST. Thus, more than 70 percent of employers who have participated in auto enrollment have done so through NEST.

Employers

Many employers have signed up with NEST due to difficulties in covering all of their employees through a pension provider. Thirty-five percent of employers reported that pension providers they approached were unwilling to enroll their entire workforce, presumably to avoid enrolling the lower-paid employees who would have small account balances.[40]

Employers can use NEST as the sole plan for all their workers; as an addition to an existing plan for a particular group of workers; as an entry-level plan to cover the waiting period of an existing plan; as a base plan with another plan to make for additional voluntary contributions; or as a catch-all plan for all eligible workers who have not joined an existing plan.

NEST currently charges no fees to employers who wish to use it as the pension plan for their employees. However, some commentators have speculated that it may charge employers in the future as it seeks to pay off its loan from the government that it used to get established. The feature of no cost to employers provides an advantage to NEST, as generally employers not using NEST must bear some cost to run a pension plan or to hire a pension service provider to do so.[41]

The costs of NEST that are shouldered by employers in other plans must be ultimately paid by someone. In the case of NEST, and generally with pension plans, presumably these costs will be paid by participants through higher fees. Also, using NEST is not completely free to employers because they must purchase appropriate payroll software to allow them to transmit contributions to NEST.[42] Companies like ADP provide payroll services to businesses in the U.K.

NEST was designed to make it easy for employers to comply with the auto enrollment requirement that every employer provide a pension for its employees. Many employers that already have a pension plan intend to use their existing plan for auto enrollment of employees not currently participating in the plan. However, less than a third of the employers with an existing plan used that plan for auto enrollment.[43]

Employers are required to transmit their contributions and employee contributions to a pension plan. Of the employers who established automatic enrollment with NEST, 88 percent were using payroll software and nearly all had purchased automatic enrollment software.[44]

One issue with NEST is the complexity of auto enrollment for employers. As of 2015, 1.3 million employers were still scheduled to join the auto enrollment system. Of these, 84 percent employ fewer than ten workers and 64 percent employ fewer than five workers. Among the smaller employers, roughly 200,000 do not currently have payroll software that can be upgraded to handle auto enrollment.

Contributions to NEST

NEST provides workers with flexible contributions, as it permits workers to increase their regular contributions or to make lump sum contributions. In tax year 2016-2017, there is a contribution limit of £4,900 a year, but starting in April 2017 there is no maximum limit on contributions and workers can contribute as much as they want. Contributions are not tied to employment. A worker who loses a job or stops working for any reason can continue to contribute to NEST. Currently, NEST is unable to accept money transferred from another plan, but that restriction will be lifted in 2017. Less than one percent of participants make additional contributions.[45] As well as opting out of participation, workers can also temporarily suspend their contributions and later restart them.

Investments

A worker enrolling in NEST is automatically put into a retirement date fund based on the year in which the worker turns age 65, or the year he or she will be eligible to receive their State Pension benefits.[46] NEST refers to these funds as retirement date funds, but elsewhere they are called target date funds (TDFs) or lifecycle funds. NEST has 47 retirement date funds corresponding to each calendar year in the future at which participants would be eligible to receive their state pension benefits. This is a much larger number of funds than most U.S. defined contribution plans, including the Federal Thrift Savings Plan (TSP) which is offered to federal government workers, members of Congress, and members of the military. The TSP only offers five TDFs, which are banded over five- or ten-year periods. The default investment is a retirement date fund tied to eligibility age for collecting State Pension benefits, but workers can notify NEST if they wish to have their investments in a different retirement date fund or in a non-retirement date fund.

The retirement date funds are based on basic underlying funds. The NEST investment classes include international and U.K. large-cap stocks (large companies), developed country small-cap stocks (small companies), emerging market stocks, U.K. and international government bonds, high-yield bonds, U.K. investment-grade corporate bonds, inflation-linked bonds, money market investments, and U.K. and domestic real estate. In 2016, NEST added an emerging market bond fund, thus further diversifying the funds offerings. The retirement date funds are well diversified. By comparison to the TSP, which is generally considered to be a well-structured plan, NEST includes emerging market stocks, international government bonds, and real estate, which the TSP does not include.

The NEST retirement date funds follow different glide paths compared to most U.S. TDFs. The glide path is the path the portfolio mix follows as the retirement date approaches. Rather than gradually becoming more conservative over the full length of a person's working career, the retirement date funds are relatively conservative for the first five years, as they strive to preserve capital so as not to discourage young savers when they experience losses. During the next approximately 30 years, the investments are relatively aggressive, with a target rate of return of three percent above inflation.[47] Then, during a third phase of approximately ten years preceding the retirement date, the funds are more conservative. Between the phases there is a relatively short period during which the portfolio mix adjusts to the level of risk of the next phase. The retirement date is the age at which the worker can receive State Pension benefits, unless the worker notifies NEST that they expect to retire at a different date. NEST keeps fund costs down by selling stocks from funds that are nearing retirement age to funds for younger workers.[48] For TDFs dated 2020 or earlier, NEST assumes that because relatively

small amounts will have been accumulated that the account will be liquidated as a lump sum. Thus, the asset mix ends up in low-risk, cash-equivalent investments.

The glide path chosen by NEST can be criticized on several grounds. The glide path goes to retirement, rather than through retirement, meaning that it reaches its most conservative position at retirement. Given that many people may be retired for 20 or 30 years, some U.S. commentators argue that the glide path should continue into retirement.[49] Also, the glide path does not distinguish between the risk preferences of different workers. A simple extension that would take that into account would be to have a low-risk, moderate-risk, and higher-risk glide path for each target retirement date.

A feature of the glide path that also differs from that of most U.S. TDFs is that it is not completely determined in advance, but can vary at any point in time within an allowable range. Thus, the glide path is actively managed, with the trustee taking into account market conditions in determining the exact glide path followed.

The NEST website indicates that NEST believes the retirement date funds are the best option for most people. However, NEST does provide five other investment options: a higher risk fund, a lower growth fund, an ethical fund, a Sharia fund, and the pre-retirement fund. The higher risk fund takes more risk than the retirement date funds, while the lower growth fund takes less risk than those funds. Taking a paternalistic approach, NEST automatically moves people from the higher risk fund to the TDF appropriate for their age when they are ten years away from their selected retirement date. Participants can over-ride this switch by picking a higher age as their expected retirement age. The ethical fund is for people concerned about the effects organizations have on the environment and society in areas such as human rights and the environment. It follows a similar risk path as the retirement date funds.

The Sharia fund takes an investment approach based on Islamic law. It does not invest in bonds and invests solely in stocks. A Sharia fund is not commonly an option in other retirement plans in the U.S. public and private sectors. It was believed in the U.K. that some people would opt-out of auto enrollment if a Sharia fund were not available. The pre-retirement fund is for people who start saving with NEST relatively near their retirement date. While the provision of options seems like a good idea, less than one percent of participants make an active choice.[50]

NEST currently invests the assets in NEST accounts through investment funds provided by leading fund management companies, including BlackRock, State Street Global Advisers, UBS, and HSBC.

The NEST funds are actively managed, but some of the underlying funds may be index funds. The NEST trustees are responsible for the investment decisions. The investment choices made by NEST are insulated from political influence because NEST is run completely independently from the government.

NEST plays an active role in voting the shares it owns. NEST has a public statement concerning how the shares it owns should be voted. Its fund managers are directed to vote in accordance with that statement.[51] Because it will eventually control a large amount of assets, it will have considerable influence over some companies. As long-term investors, NEST has stated that it will incorporate environmental, social and governance (ESG) factors in its investment management decisions.

Management

NEST is a master trust, meaning that it is a collection of pension funds from different employers that are pooled together to obtain wholesale prices and rates unavailable for individual employers investors. NEST is managed by as many as 14 trustees as a jointly trusteed fund. The NEST trustees – who represent employers and employees – are appointed by the Pensions Minister, an appointed government official. The trustees select the funds to be offered to participants. NEST outsources the management of its investment funds. NEST decides on the composition of its retirement date funds and on the glide path of those funds. It also outsources to a single company, Tata Consultancy Services (TCS), for most of its administrative functions.[52] TCS is an information technology (IT) services, consulting, and business services company.

Fees

NEST advertises that it has a simple fee structure and that its fees are low. Given that NEST is the plan for many small employers and employees with lower wages, fees are an important consideration. It charges the same fees to all

participants, no matter how small or large their account balance. It also charges the same fees for all of its investment options. In those respects, the fee structure is simple.

The NEST fees are 0.3 percent (30 basis points) of assets plus a modest charge of 1.8 percent of contributions (a load fee). The charge on contributions is made on all contributions, including those by employers and the government. This two-part fee structure is more complex than the usual structure in the U.S. that charges only based on assets in the participant's account although some plans have per account fees. The two-part structure makes it difficult for most people to compare its fees to the fees of service providers who charge only based on assets.

Recognizing the problem of the lack of transparency of its fee structure, the NEST website provides the following example. If a person had an account of £10,000 and contributed £1,000 that year, the fees would total £48 (0.3 percent times 10,000 = £30 plus 1.8 percent times 1,000 = £18) or roughly 50 basis points a year. This raises the question of why NEST doesn't just charge 50 basis points, which would be simpler and more transparent. Part of the reason for the charge on contributions is presumably that it is designed to pay off the loan from the U.K. government that NEST received to pay for start-up expenses and it might be temporary.

While NEST advertises that it has low fees, by U.S. standards, its fees are not as low as some plans, but these plans have reached scale. For example, the TSP for federal government employees charges fees of three basis points but had higer expenses in the early years of the program when expenses needed to be covered by accounts with small amounts accumulated in the funds. While Vanguard has funds in the U.S. that charge fees of five basis points, they require minimum investments of $10,000,[53] which is an amount a person could expect to have after a few years of participation in a pension plan. Schwab offers target date funds charging eight basis points,[54] while Vanguard offers TDFs for employer-sponsored plans charging ten basis points. Thus, the NEST charges are roughly five times the level of charges for low-fee TDFs in the U.S. Even by U.K. standards, NEST fees are not low. Vanguard U.K. offers a FTSE index fund that charges eight basis points.[55]

It is to be expected that as its asset base grows and the assets per participant also grow, NEST will reduce its fees. As an account grows, the total fee will automatically decline, as the contributions become increasingly small relative to the growing asset base. One feature that will help keep its fees relatively low is that NEST is established so that all interactions with it can be done online.

Changing Jobs

If an employee loses his or her job, that person can continue contributing to NEST as long as the contributions are at least £10 per contribution. If the person changes jobs and the new employer participates in NEST, the employee can continue in the plan with employer as well as employee contributions. If the new employer does not participate in the plan, the employee can continue with their contributions, so long as their contributions are at least £10 per contribution. Thus, NEST can be used as a pension plan by low-income people and people with irregular income, as it permits small, irregular contributions.

NEST does not allow money to be transferred out to an employer-sponsored pension plan. This separates it from the U.S. government plan called myRA, where participants are required to transfer the money out to a private sector Roth IRA after they reach an account balance of $15,000.[56] This feature of myRA is designed to ensure that those accounts do not compete with accounts managed by private sector providers.

Pre-Retirement Cash Withdrawals

Unless employees opt-out within the first month of participation, money contributed to the fund stays in NEST until retirement, which is a minimum age of 55. There is limited pre-retirement liquidity — pre-retirement cash outs, hardship withdrawals, and loans are not permitted. Workers with serious medical conditions or workers who are unable to work due to a disability may be able to take an early withdrawal. This locking-in of contributions differs from the U.S., where employees can make hardship withdrawals before retirement age or non-hardship early withdrawals that are subject to a tax penalty and, in some cases, are forced out of a plan if they have a small balance

Employees can opt-out after the first month for future contributions, but all past contributions remain in the plan. Employees who opt-out are automatically re-enrolled every three years if they remain with the same employer and continue to meet the age eligibility requirements. If they

change employers, they will be automatically re-enrolled within three months of starting with the new employer.

Post-Retirement De-accumulation

NEST was designed to encourage saving through auto enrollment. It was not designed to help people with asset de-accumulation in retirement. Retired employees can start receiving benefits at age 55, but NEST currently does not offer de-accumulation options. It does not provide annuities, nor does it allow the worker to gradually draw down their account. Since NEST does not currently offer annuities, the purchase of an annuity could only be made through a lump sum payment, after the money had left a NEST account. The current options are based on the understanding that the amounts invested in NEST by participants will be small because NEST has only been in existence a few years. NEST is working on developing other options, such as annuities and phased withdrawal, that would be appropriate for people with larger account balances.

In the U.K., the issue of NEST providing de-accumulation options is currently being discussed.[57] Steve Webb, a former Minister of State for Pensions, argues that NEST should not expand into offering de-accumulation products because it is already operating at a deficit and should not expand into new services. He also argues that the case must be made that the private sector cannot provide that service. Furthermore, because the average NEST participant only has an account of about £300 due to the short time that auto enrollment has been required, there is no immediate need for NEST to provide de-accumulation products.[58] In the future, there may be a role for NEST in providing annuities because U.K. research shows that low-earners with small annuities receive annuities that are relatively costly.[59] An issue is whether there should be a default for the de-accumulation phase, just as there is a default for the accumulation phase.

Unfair Competition

Another issue with NEST is that some private-sector financial services providers have criticized that it creates unfair government competition with the private sector. While the U.K. remains part of the European Union (E.U.), some companies have threatened to take a case to the E.U. that NEST constitutes unfair government competition according to E.U. rules. The fact that more than a third of employers enrolling with NEST were rejected by private sector providers indicates that at least to some extent, NEST is not competing with private sector providers.

NEST's Debt

As of March 31, 2016, NEST had a loan from the U.K. government of £460 million. That debt compares to participants' assets on the same date of £827 million.[60] It is expected to have a loss of £93 million for the tax year 2016-2017, and it is projected to have a loss of £109 million in the tax year 2017-2018.[61] Assuming that the liability for the debt ultimately falls on the participants through the fees they pay, the debt appears to be a major problem for NEST and its participants.[62] NEST has indicated that it cannot give a timeframe for the repayment of the government loan.[63] The assets managed by NEST will need to grow considerably before the liability of the loan becomes a relatively small problem.

III. CONSEQUENCES OF THE UK NEW RETIREMENT SAVINGS PROGRAM

Positive Consequences

A positive consequence of auto enrollment is that workers are placing a higher priority on saving for retirement. A survey conducted by NEST in 2011 shows that when workers were asked what they would do if they had extra money, saving for retirement was listed as the seventh priority, after buying clothes. In 2013 and 2014 surveys, saving for retirement had risen to the third priority behind travel and saving for a rainy day. When asked in 2011 if they thought auto enrollment was a good idea, 63 percent said yes, and by 2014 that figure had risen to 77 percent.[64]

Unintended Consequences

Because more women than men work in jobs with wages below the auto enrollment threshold, their employers may keep their wages below the auto enrollment threshold in order to prevent paying contributions. Thus, many more women than men will not have access to employer contributions. Some women who are eligible may opt-out because they will not be able to afford the four percent contribution requirement. Many women will not be able to receive employer contributions when they are absent from their job to take care of their children, families or a relative.[65]

Employers

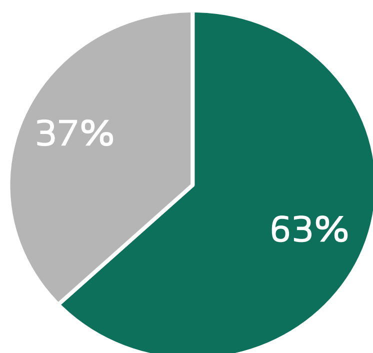
Many employers who already have a pension plan intend to use their existing plan for auto enrollment of employees who are not currently participating in their plan. However, less than a third of the employers with an existing plan used that plan for auto enrollment.[66]

Employers are required to transmit employee contributions and their contributions for employees to a pension plan. Of the employers who established automatic enrollment with NEST, 88 percent used payroll software, and nearly all had purchased automatic enrollment software.[67]

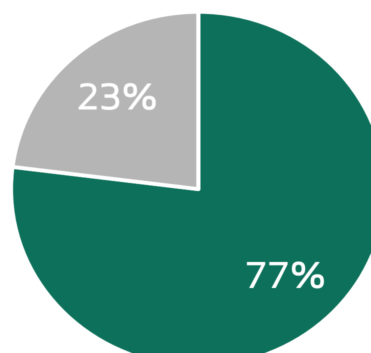
The mandated contributions may be a burden for some employers, particularly small employers, and generally any employer facing financial distress.

Figure 4: **NEST Auto Enrollment Has Become More Popular**

2011: 63% Say Auto Enrollment Is A Good Idea



2014: 77% Say Auto Enrollment Is A Good Idea



Source: NEST, 2015, "NEST Insight 2015: Taking the Temperature of Auto Enrolment" https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/nest-insight-2015,pdf.pdf.

IV. U.S. RETIREMENT DEVELOPMENTS

Facing the fact that half of British households have nearly no savings or investments, the U.K. has gone beyond the U.S. in its efforts to expand pension coverage. In 2001, the U.K. required that all employers with five or more employees offer a pension plan. That program was unsuccessful, and many plans had no participants. In 2008, the U.K. went a step further by requiring automatic enrollment. Preliminary evidence indicates that this new program has succeeded in expanding coverage in the U.K. by six million workers. A total increase in coverage of nine million workers is expected by 2018. In addition to expanding retirement coverage, these programs have utilized auto enrollment to participation and required mandatory contributions, which have further increased retirement savings.

Additionally, to simplify the task for employers, the government has provided a government-sponsored plan, NEST, that will accept any employer that wishes to use it in comparison to private sector pension providers that are not required to accept any employer. The mandate is now being extended to small firms and the minimum contribution rate is scheduled to increase in the future, so the whole story of the success of the program in increasing coverage is not yet known. One of the unknowns in the development of auto enrollment is the effect of the increase in the minimum contribution rate on worker opt out rate. The change would be expected to increase opt out rates, but the magnitude of the effect is unknown. Doubtlessly, the program will be modified over time, as experience indicates features that can be improved through policy changes.

Even though the U.S. faces a similar savings shortfall, with nearly 45 percent of individuals have no retirement savings, the U.S. has not implemented a sweeping retirement savings initiative. Instead, the U.S. has acted incrementally and recently enacted MyRA, a starter retirement savings initiative sponsored by the U.S. Treasury, and various states, such as Oregon, California, Connecticut, Illinois, and Massachusetts, have adopted retirement savings programs. If the U.S. were to follow in the footsteps of the U.K. and address the current retirement savings shortfall, these programs would be expanded and would utilize features such as auto enrollment and required mandatory contributions, in order to increase coverage, expand enrollment and boost retirement savings. Without mandates, access to payroll savings programs, or mandatory employee contributions, which remain controversial in the U.S., American workers will likely lag behind workers in the U.K. when it comes to retirement security.

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1612 K Street, NW
Suite 500
Washington, DC 20006
www.nirsonline.org
info@nirsonline.org
tel: 202.457.8190
fax: 202.457.8191