

# THE U.K.'S AMBITIOUS NEW RETIREMENT SAVINGS INITIATIVE

BY STEVEN A. SASS\*

## Introduction

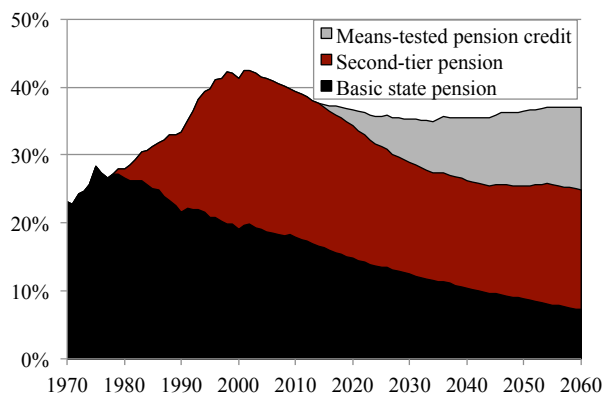
The United Kingdom is rolling out a broad retirement savings initiative with an objective similar to President Obama's recently announced "myRA" program. Both aim to encourage retirement saving among workers who do not currently participate in employer plans, typically those with average to low incomes. Both also steer new participants initially into low-risk investments. The U.K. initiative, however, is far more ambitious. It requires all employers to "auto-enroll" their uncovered workers, with the right to "opt out." And the government created a new non-profit entity, the National Employment Savings Trust (NEST), to provide employers with high-quality, low-cost plans.

This *brief* reviews the U.K. initiative to date. The first section discusses the creation of the employer mandate. The second section reviews the development of NEST. The third section explores two issues that merit further consideration – the design of NEST's default Target Date Funds and the government's efforts to limit NEST's market reach. The final section concludes that the U.K. initiative reflects the best contemporary thinking on the design of 401(k)/IRA-type retirement savings plans, but its success in addressing a critical national retirement income challenge remains untested.

## The Employer Mandate

The United Kingdom entered the new century with a serious retirement income problem. Its government old-age pension benefits – among the least generous in the industrial world – were on track to become even less generous, with retirees increasingly dependent on means-tested benefits (see Figure 1). The

FIGURE 1. ACTUAL AND PROJECTED GOVERNMENT PENSION INCOME AS A PERCENT OF AGE-50 EARNINGS, AS OF 2006, 1970-2060



Note: These data assume a median earner who retires at the State Pension Age with no other income.

Source: Bozio, Crawford, and Tetlow (2010).

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decline in government pensions was an especially serious problem for average- and low-wage workers, who typically have little or no retirement savings.

To shore up future retirement incomes, the government in 2001 imposed a retirement savings mandate on employers, requiring them to offer their employees a plan. It required all employers with five or more employees, and no retirement program, to offer workers a “stakeholder” retirement savings plan, with fees capped at 1.5 percent of assets for the first 10 years, and 1 percent of assets thereafter.<sup>1</sup>

Despite the mandate, the stakeholder initiative failed to gain traction. Financial services firms viewed the target market – average- and low-wage workers and small employers – as unprofitable. Marketing and set-up costs were high. Plan providers were also required to offer trustworthy advice, and advising participants who would likely be eligible for means-tested benefits was costly and risky. At the same time, the program did not attract much interest from workers: most stakeholder plans had no contributors.<sup>2</sup>

The Pensions Commission, created in 2002 to conduct a thorough review of the nation’s private retirement income system, concluded that retirement incomes would become “increasingly inadequate and unequal” unless the nation introduced significant reforms. These reforms included an increase in the State Retirement Age, an increase in government pensions available at that age (which would sharply reduce dependence on means-tested benefits), and a revamped employer mandate. Rather than just requiring employers to *offer* a plan, the Commission would require employers to automatically enroll their workers. It would also require matching employer contributions.<sup>3</sup>

In 2008, Parliament enacted such a mandate. When fully phased in, employers without a better plan will be required to auto-enroll their workers in a retirement savings plan in which workers contribute 4 percent of after-tax earnings, the employer provides a 3-percent match, and government adds 1 percent as tax relief on the worker contribution (see Table 1).<sup>4</sup> Accumulations will then be treated like savings in any U.K. retirement plan: participants cannot access these savings before age 55; by age 75 they must use at least 75 percent to buy an annuity, and can withdraw up to 25 percent tax-free.<sup>5</sup>

TABLE 1. PHASE-IN FOR NEW EMPLOYER MANDATE

Phase-in period	Employers affected	Minimum contribution		
		Employee	Employer	Government
Oct. 2012-Feb. 2014	250+ employees	1 %	1 %	0.25 %
By Apr. 2015	50-249	1	1	0.25
By Apr. 2017	< 50	1	1	0.25
By Feb. 2018	New firms <sup>a</sup>	1	1	0.25
By Oct. 2017	With DB plans <sup>b</sup>	1	1	0.25
Oct. 2017	All	3	2	0.75
Oct. 2018	All	4	3	1

<sup>a</sup> Firms established after April 2012.

<sup>b</sup> Firms with traditional defined benefit or hybrid plans.  
Source: U.K. Department for Work and Pensions (2012).

## The National Employment Savings Trust (NEST)

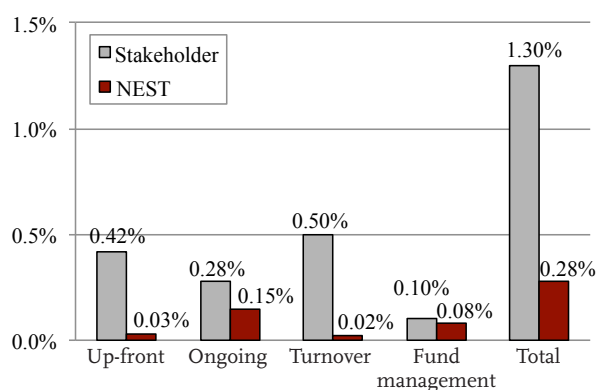
For the U.K.’s new initiative to make a significant contribution to retirement incomes, it had to be low cost. The Pensions Commission targeted a 0.3 percent fee, typically found only in large plans with high-wage workers.<sup>6</sup> Since financial services companies would find such a fee unprofitable for smaller plans serving lower wage workers, the Commission proposed the creation of a financially self-sustaining public entity to provide such low-cost plans to any employer. In response, Parliament created NEST in 2010.<sup>7</sup>

NEST has a challenging assignment. It is charged with providing high-quality retirement savings plans, for a fee of 0.3 percent of assets under management, to an estimated 750,000 largely small employers, with two to four million largely lower-wage employees. These figures represent about two thirds of all U.K. employers and roughly 10 percent of all workers. To meet the challenge, the Pensions Commission, and subsequent government task forces, developed a strategy with four key components: 1) a low-cost

national payment collection system; 2) investment options built from low-cost funds from private financial services providers; 3) accounts that follow workers as they move to new employers; and 4) the elimination of the requirement to provide financial advice.

This strategy should reduce costs sharply relative to those in the stakeholder pensions (see Figure 2). Significant upfront costs, driven by the need to interview participants to provide advice, would be cut by eliminating the requirement to provide advice since employer and government contributions make savings a sensible choice and by auto-enrolling participants into default investments. Ongoing costs, primarily for account maintenance, and turnover costs, for maintaining a chain of legacy accounts and setting up new ones, would be sharply reduced by the creation of one large system of portable accounts.

FIGURE 2. ESTIMATED MANAGEMENT COSTS UNDER STAKEHOLDER AND NEST PLANS



Note: The cost estimates are for a median earner, age 40, in a 23-employee company with combined employee-employer contributions of 8 percent of pay. Source: Pensions Commission (2005).

This strategy could succeed once the program attains scale but, until then, costs will far exceed revenues. So the government is lending NEST the funds needed to get the program up and running, with interest equal to the government’s cost of funds. Until the loan is repaid, NEST is charging an additional 1.8 percent fee on contributions. As it will take an estimated 20 years to repay the loan, NEST costs for early participants should be roughly equivalent to a 0.5 percent fee on assets under management.<sup>8</sup>

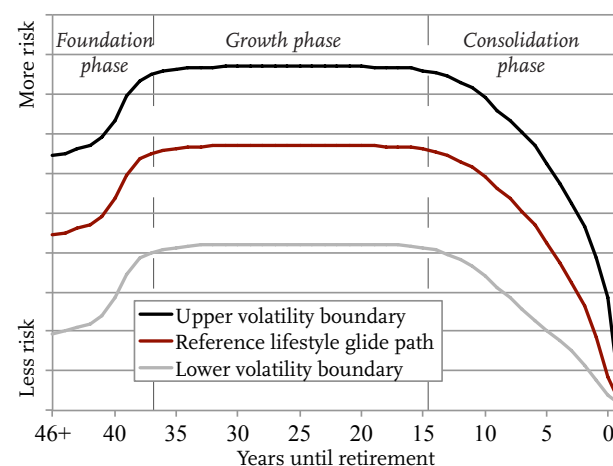
## Issues in NEST’s Design

It is too early to judge NEST’s success. The program has an attractive website, a set of funds assembled in-house from low-cost funds offered by major investment houses, a panel of annuity providers for those entering retirement, and 250,000 participants as of July 2013.<sup>10</sup> Nevertheless, two issues in NEST’s design merit further consideration.

### Target Date Fund Design

NEST makes Target Date Funds (TDFs) its default investment option, as do most U.S. 401(k) plans with auto-enrollment. But NEST funds differ in three important ways (see Figure 3). First, NEST presents its TDF glide path in terms of risk, not asset allocation, as is commonly done in U.S. 401(k)s. Second, in contrast to U.S. practice, NEST TDFs invest the savings of workers in their 20s in relatively low-risk investments. The explanation is behavioral, not financial. When researching their investment options, NEST heard many young workers say they might stop saving if they saw the value of their account fall. So NEST adopted an investment strategy designed to produce rising nominal balances for workers just starting out.<sup>11</sup> The President’s myRA program adopted this approach. Third, NEST TDFs have a “to retirement” rather than a “through retirement” glide path, providing a relatively smooth, low-risk transition to annuities, which NEST participants are required to buy at retirement.<sup>12</sup>

FIGURE 3. THE NEST TARGET DATE FUND DESIGN



Source: National Employment Savings Trust (2014b).

## *NEST's Market Boundaries*

The government – and financial services firms – were concerned that NEST might expand beyond its target market and undermine, not complement, private sector providers. As NEST got a 20-year loan at advantageous government borrowing rates, it would be unfair competition. As a result, the legislation imposed restrictions to focus NEST on its target market and to check its expansion. The key restrictions were a cap on contributions, currently £4,500 a year, indexed to wage growth, and a prohibition on transfers between NEST accounts and accounts in other plans.<sup>13</sup>

A 2010 independent review of the new initiative recommended the elimination of these restrictions. It objected to the contribution cap for two reasons. First, the cap would create the need for two plans – NEST for the rank-and-file and another plan for higher-wage workers – adding cost and administrative complexity. Second, workers could view the cap as a ceiling for how much they need to save. The review committee objected to the prohibition on asset transfers for more systemic reasons. It thought workers should move their pension “pots” when changing employers. This change would eliminate the complexity of multiple retirement accounts and provide workers a clearer picture of how much they have in retirement savings and how those savings are invested. The review committee recommended that Parliament remove the restrictions after the program is fully phased in.<sup>14</sup> After gathering comments from other parties, the government accepted these recommendations.

It is difficult to predict NEST's market position after these restrictions are lifted. Will it expand beyond its “target market” and compete with private sector providers? Will its fees be seen as an industry benchmark, putting pressure on more expensive providers? Will NEST's menu of investment options, designed for average- and low-wage workers, limit its appeal beyond its initial target market? Or might it broaden its appeal by offering other investment options, perhaps including funds from other providers?<sup>15</sup>

## Conclusion

The U.K. initiative is a bold experiment. It aims to raise the retirement savings of those with the greatest saving deficits – average- and low-wage workers and those not covered by employer plans. And it aims to do that using the best contemporary thinking on retirement plan design. President Obama's recently announced myRA program has a similar ambition and also offers workers not covered by employer plans a low-risk, no-cost retirement saving option. The U.K. experience, however, suggests that take-up in myRA could be low without auto-enrollment and matching employer and government contributions. U.S. 401(k) providers might also find other features in the U.K. initiative of interest, such as NEST's TDF design in plans for average- and lower-wage workers.

It remains to be seen if the new initiative succeeds and the United Kingdom avoids a future with “increasingly inadequate and unequal” retirement incomes. But it would surely arrive had the nation continued on its previous course.

## Endnotes

- 1 Johnson, Yeandle, and Boulding (2010).
- 2 Pensions Commission (2004).
- 3 Pensions Commission (2005). The mandate required employers to auto-enroll workers from age 22 to the State Retirement Age (currently 65 for men and 60 for women, rising to 66 for both men and women by 2020) with earnings above the threshold for participation in the state pension program (£9,440 a year in 2013/14). See Thurley (2013).
- 4 Workers can contribute less than 4 percent of after-tax earnings to the extent that their employers contribute more than 3 percent. Employers can also establish a 3-month waiting period for plan participation, to avoid administrative challenges in covering transient and seasonal workers. See Government of the United Kingdom (2008).
- 5 Retirees with retirement incomes of £20,000 or more are not required to purchase an annuity, nor are those with small accumulations – £16,000 or less in 2007/08. See HM Revenue & Customs (2014); and Thurley (2010).
- 6 Pensions Commission (2005).
- 7 NEST is a “non-departmental public body ... that operates at arm’s length from government” with a “duty to act in the interests of scheme members.” The Secretary of State for Work and Pensions named its initial trustees, along with members of advisory panels representing workers and employers. NEST is now largely self-governing, “though accountable to Parliament through the U.K. Department for Work and Pensions.” See National Employment Savings Trust (2014a).
- 8 Thurley (2013).
- 9 Such an increase was enacted in 2007. Bozio, Crawford, and Tetlow (2010).
- 10 The menu of investment options includes Target Date Funds, Ethical, Sharia, Higher Risk, Lower Growth, and Pre-Retirement Funds. NEST does not offer annuities. But as most NEST participants are required to purchase an annuity by age 75, it provides a panel of selected providers that participants can use if they choose (Thurley 2013).
- 11 National Employment Savings Trust (2014b).
- 12 As noted, well-to-do retirees, with an annual retirement income of £20,000 or more, are not required to purchase an annuity (HM Revenue & Customs 2014). But NEST TDFs are not designed for the well-to-do. A NEST-like “to retirement” TDF could be preferable for U.S. workers who find it advantageous to use their 401(k) savings to “buy an annuity” from Social Security – to use their savings to delay when they claim to increase their monthly benefit. This strategy could be especially advantageous for average- and lower-wage workers with little ability to bear financial risk in retirement. See Sass (2012).
- 13 Thurley (2013).
- 14 Johnson, Yeandle, and Boulding (2010).
- 15 NEST’s greatest value-add could be its system for collecting contributions, making payments, and maintaining worker accounts – tasks with large economies of scale. This approach was modelled on the Swedish mandatory retirement savings program, where private pension providers use a publicly created infrastructure to handle transactions and bookkeeping. This design significantly cuts the cost of pension provision and allows these firms to focus on their primary interest and value-add: investing retirement savings and advising clients. See Pensions Commission (2005); and Sundén (2004). NEST makes such a system of centralized bookkeeping and transaction processing feasible in the United Kingdom.

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