Georgetown University
Center for Retirement Initiatives
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Blog Post, November 2018, 18-09

The Next Generation of NEST Program Reforms in the UK: Anticipating Some Challenges Will Strengthen the Foundation for Continued Success

By Will Sandbrook

Two years ago, I wrote a blog post for this site with Keith Ambachtsheer, from the International Centre for Pension Management, giving an update on plans to extend private sector pension coverage in the United Kingdom (UK) and Canada. In the UK context, this effort has focused on creating a mandate for employers to automatically enroll eligible workers — much like approaches now being developed and rolled out in the United States (U.S.) in states such as California, Oregon, Illinois, and several others. In our version, we established the National Employment Savings Trust (NEST), a pension plan structured much like an open multiple employer plan (MEP), available to any employer wishing to use it to meet their obligations. Any employer can use NEST, but no one is required to because they also can choose from available private sector options. However, NEST does ensure that all employers have at least one high-quality, low-charge path to compliance. At the same time, it also enables existing and new providers to innovate for, and benefit from, this new market of pension savers.

NEST will probably never feel comfortable declaring complete success, either for this broad policy or for our own role within it — at least, not until the current generation of workers has been able to retire with a meaningfully improved standard of living. Merely getting this far — to what we might call "the end of the beginning," to borrow from Winston Churchill — has presented many challenges, and no doubt, there are many more to come.

Early Indicators are Positive

Across the UK, around 10 million people have been automatically enrolled in retirement plans since 2012, with many saving for retirement for the first time. More people are now saving for their retirement than was the case in 2011. More than 80 per cent of UK workers are participating in a second-pillar pension through work — the highest rate we've ever had, and far higher than in the "golden age" of defined benefit (DB) pensions. Nationally, opt-out rates have been far below predictions — around 10 percent. For the NEST program, those now being enrolled every day as an ordinary part of starting a new job, that rate is even lower — around 6 percent.

In the UK, we started out with the mandatory minimum contribution level set deliberately low at 1 percent for the employee, matched 1 percent by the employer. In April 2018, those levels rose to 3 percent and 2 percent, respectively: a critical program milestone to determine whether the low opt-out and cessation rates would be maintained. So far, all signs are that they have been, and we are optimistic that the same will be true of the second increase, to 5 percent and 3 percent respectively, scheduled for April 2019.

Time to Consider the Next Generation of NEST

While it is too early to claim complete success, it is not too early to begin to anticipate, as we move into the "steady state" phase of auto enrollment, the next set of program challenges on the horizon. This was one of the reasons that we established the NEST Insight Unit in 2016, a collaborative research and thought leadership group within NEST that I am fortunate to lead. Our work program is all about the challenges facing the "DC generation" of today — the market of lower and moderate earners for whom a defined contribution (DC) provision will most likely form all of their supplementary retirement income beyond what they get from our Social Security equivalent. We are working to understand the steps that NEST, the broader industry, and policymakers can take to ensure the best possible outcomes in retirement for these groups.

We will need to address several challenges in this next phase of the NEST program. The Georgetown University Center for Retirement Initiatives (CRI) 2018 Policy Innovation Forum did an outstanding job framing several of these challenges for policymakers in the U.S. We are focusing on many of the same challenges in the UK. Here is an overview of some of those challenges.

How do you increase engagement among workers brought into saving by nudges and inertia?

While auto enrollment has helped workers begin to save and their opt-out rates are low, the behavioral nudges and savings inertia that leads them to stay in the program can also be a double-edged sword. Once in NEST, most of our members take no further action of any kind. Only 16 percent of them have registered their online accounts. Fewer than 1 percent make contributions above the minimum. Although auto enrollment addresses coverage and take-up levels, for some participants, the default contribution rates might be too low to achieve the income they will want when they reach retirement. Smarter or more-personalized default contribution levels may be part of the answer in the longer term, but truly optimal outcomes are likely to require that more individuals take further action.

DC savers in the UK also now face many more choices for their income phase because the compulsory annuity purchase requirement was abolished in 2014. This now requires greater active choice or decisions on the part of the worker to drive good long-term retirement income outcomes.

What should the retirement income choices be?

The greater choice offered to DC savers in decumulating their assets presents opportunities, but also risks. Some savers in NEST are likely to have modest total retirement savings that fall outside the traditional market for advice and conventional drawdown products. Few are likely to voluntarily purchase a life annuity. What product or products will work best for them, and how can they be supported or guided into those products while preserving choice? NEST has already conducted extensive research on these issues and published a "retirement income blueprint" in 2015, but there is much to do before the retirement income picture is properly settled.

How should DC investment approaches evolve?

Many of the global pension success stories when it comes to investment have been in the DB space — for example, with the highly praised "Canadian model," under which DB plans are imported to the pensions space, the practice pioneered in the Yale endowment model of investing in illiquid asset classes such as infrastructure. For DC plans, the illiquidity premiums available in these asset classes represent a huge opportunity for savers. The Georgetown University CRI released a study at its 2018 Policy Innovation Forum that examined whether the inclusion of such asset classes in target date funds — one of the most-common investment options used in U.S. DC plans — would help boost retirement income. Some such classes have added diversification benefits. For example, younger savers in the UK are now less likely to own property than any previous generation at an equivalent age, meaning residential property may be a particularly attractive class for exposure for these groups. However, DC plans face challenges in accessing these classes directly, due to reporting and liquidity requirements, as noted in the CRI report.

This is something NEST, among others, has started to consider, in part by recently launching a procurement for a private credit mandate that directly challenges the industry to come up with innovative approaches in this area. But there is clearly a broader question about how DC plans can access the benefits of these asset classes for savers.

How should retirement savings interact with other important considerations to improve the overall financial wellbeing of savers?

In the UK, as in the U.S., many lower- and moderate-income households have little or no access to emergency savings and would have to rely on borrowing to fund any significant unexpected cost. In the UK, emergency access to a retirement account is not available, and that does have the effect of limiting leakage from retirement savings.

However, this rigidity may contribute to making it harder not only to get workers to save for retirement but also could inadvertently lead to less optimal overall financial wellbeing. Workers may choose to stop saving to repay debts or, to save, carry some inefficient combinations of debt and long-term saving with nothing in between for emergencies. In an extreme case, they could suffer financial stress that affects their work or ability to work (not being able to afford a car repair, for example).

All such scenarios can contribute to worse overall financial outcomes in retirement. Workers would generally be better off if, in addition to their retirement savings, they could also achieve goals of reduced housing debt, for example, by the time they reach retirement. How can those newly saving for retirement be helped to also save for other, nearer-term needs and build financial resilience for both today and retirement in the future? Do the mechanisms developed for pensions — auto enrollment and payroll deduction — play a role in the answer? And how might linked or hybrid products help, such as retirement savings plan "sidecar" accounts, already being considered and adopted in the U.S.? Could allowing for flexibility in design to maintain some access to a slice of contributions help more workers save, and perhaps save more while also addressing the reality of other financial challenges they may face?

What about those who lack traditional employer relationships and are left out of the auto enrollment framework?

Given the focus on the "future of work," how can we facilitate auto enrollment and payroll deduction equivalents for workers who lack a traditional employer relationship? In the UK, self-employed and gig-economy workers tend not to save for retirement, and many lack clear alternative strategies to fund their retirements. We need to consider how they can be encouraged to make provision for retirement. We also must identify what messages, channels, or uses of technology might help.

Conclusion

As is the case in the U.S. today, these are some of the questions and future challenges we are interested in exploring at NEST Insight as we contemplate the next generation of program reforms. As much as possible, we look to identify practical solutions and to test those using scientifically robust methods, often in partnership with academics, so we look forward to continuing our collaborations with Georgetown and other institutions. This year, we are launching a trial of a sidecar savings account, working with partners from Harvard University and the UK Money Advice Service. We are also developing a program to look at take-up among the self-employed. Earlier this year, we announced a partnership with the Aspen Institute's Financial Security Program to look at the comparative aspects of these challenges across the U.S. and UK systems.

If you're interested in knowing more, visit our website (www.nestinsight.org.uk), follow us on Twitter or LinkedIn, or get in touch with us through the Georgetown CRI. We welcome hearing from people working on similar issues, and those interested in collaborating on research or in other ways, to enable discussion. In the meantime, we look forward to pressing on with thinking about these challenges, building on the promising start made by auto enrollment, to ensure that the DC generation reaches retirement well-prepared.

Will Sandbrook is the Executive Director of NEST Insight, a former senior policy analyst in the UK Government and a member of the research committee of the International Center for Pensions Management (ICPM).

Additional Resources:

National Employment Saving Trust (NEST), "The future of retirement: A retirement income blueprint for NEST's members," 2015.

Vanguard and NEST Insight, "How the UK Saves 2018: Member experience from the National Employment Savings Trust (NEST)," June 2018.

NEST Insight, "Working for today, preparing for tomorrow: The realities of self-employment and saving," October 2018.

Nest Insight, "Liquidity and retirement savings: What's the right balance?" March 2018.