A New NEST for British Nest-Eggs

By Kerry Pechter *Wed, Aug 8, 2012*

This is the first part of a two-part article on Britain's ambitious national defined contribution fund for undersavers, a "public option" called the National Employment Savings Trust, or NEST.

The fact that 45% of American workers have no access to an employer-sponsored retirement plan has troubled U.S. policy wonks for years. But proposed solutions to the problem, such as the so-called automatic-IRA, have run into government gridlock.

In Britain, where even a smaller percentage of workers have DC plans at work, the story has played out differently.

Since before the turn of the millennium, as British employers abandoned DB plans, the government has tried to broaden DC plan coverage. In 2001, a voluntary plan, called the Stakeholders Pension, was a flop. In 2002, a national commission was formed and spent almost 10 years crafting a national auto-enrolled DC policy and legislation that ultimately yielded the National Employment Savings Trust, or NEST, a DC "public option." The legislation also requires all qualified plan sponsors to use auto-enrollment.

NEST was introduced on a voluntary basis to employers and workers in July 2011. Starting in October 2012, the new policies go into full effect. All qualified DC plans in the U.K. will start practicing auto-enrollment. Workers who have no private plan option will be auto-enrolled into NEST.

"We went live in July of last year, and we have over 100 employers working with us now," said Helen Dean, a NEST managing director in London, in an interview with RIJ. "NEST is very simple to use. All people need to know is the date they want to retire. We compare it to driving a car. You can drive a car without understanding what's going on under the bonnet."

In the first of two articles on NEST, RIJ takes a look at how NEST works, and how it resembles and differs from American-style defined contribution plans. While some of NEST's features might be transferable to the U.S., others—like mandatory employer contributions—would likely face stiff opposition. Next week, in the second installment, we'll look at how NEST evolved and how it manages participants' money.

How the U.K. does retirement

To understand how NEST works, you have to understand a little about the British retirement system. As in the U.S., there's been a hodgepodge of legacy defined benefit plans, privately provided defined contribution plans and annuities, and government-sponsored attempts to provide IRA-like vehicles to workers who have no other plan.

To sponsor a qualified (tax-deferred) plan under auto-enrollment, the employer must contribute at least 3% of pay per year and each participant must contribute at least 4% of pay, with another 1% coming in tax relief from the government. Unlike in the U.S., British DC providers can choose to enroll some employees but can turn away others. Hence, many employees remain uncovered even when the employer offers a plan.

In retirement, the U.K. government regulates the drawdown of assets, requiring everyone to buy a life annuity by age 75 with their remaining tax-deferred assets (they can cash out up to 25% tax-free at retirement) unless they can demonstrate income of at least £20,000 a year (about $35,000)—from other sources. The U.K. state pension is less robust than Social Security, involves means-testing, and may soon convert to a flat $800-a-month stipend.

NEST is aimed at the 50% or so of U.K. workers who are not currently offered a defined contribution. The NEST target audience includes young people and minorities who save little and in many cases don't understand the basics of investing or finance. Starting in October, unless their employer offers them a qualified plan, they will be auto-enrolled into NEST and, unless they choose another option, defaulted into a target-date fund.

"Every employer has to offer a pension plan," Dean (at right) told RIJ. "The employer could use NEST or a private plan," she said. "It's up to the employer to decide what to use NEST for. We will not turn any employer away who wants to use us. We don't intend to compete with private plans but to complement them.

"What's happening is that smaller employers are choosing to just use NEST, while the bigger employers are using a combination of NEST and a private plan. In companies where there's a high level of turnover and people don't stay a long time, employers might think it's better to use NEST" because of its portability from one employer to another, she added.

"Anybody who has a qualifying plan—if the employee is contributing at least 5% of pay and the employer is contributing 3%—can keep their plan," Dean said. "But every employer in the U.K. will be making a choice between using their own scheme, NEST, or a combination of the two—with different ones for different segments of the workforce."

How NEST differs from 401(k)

NEST would probably not fly in the U.S., except perhaps among U.S. government employees, since it was modeled in part on the federal Thrift Savings Plan. It includes a number of restrictions that are not unusual for Britain but which American employers and employees alike would probably find restrictive and paternalistic.

But the British, many of whom had defined benefit pensions until relatively recently, don't seem to mind DC with DB-like guardrails. More importantly, the British government is said to be serious about getting people to save more, partly because the state pension alone is deemed inadequate.

Here are a few of the ways NEST differs from U.S.-style DC plans:

Persistent auto-enrollment. Starting in October, British workers will start being auto-enrolled in whatever defined contribution plan, including private plans and NEST, that their employer offers. They can unenroll from the plan but they will be automatically re-enrolled every three years.

Mandatory contributions. NEST, like all qualified plans in the U.K., will involve mandatory contributions from both employers and participants. For private plans, the current minimum contributions, as mentioned above, are 3% for employers and 4% for participants. The government kicks in another 1% for the tax savings on the contributions. To ease the transition to auto-enrollment starting in October, contributions will start low (2% for employers and 1% for employees) and rise to the full 8% over time. This low starter rate applies to new private DC plan auto-enrollees as well as to NEST auto-enrollees.

No withdrawals. Unlike Americans, the Brits can't borrow from their DC plans and can't take withdrawals for special needs such as education expenses, a down payment on a home or medical bills. When they change jobs, they can't take a lump sum withdrawal, pay the tax (and penalty, in some cases), and spend it, as Americans can. There's no U.K. counterpart to a rollover IRA. The earliest age at which British participants can access their money is age 55, but most don't take distributions until they qualify for a state pension, which occurs at age 65 but will eventually climb to 68.

Centralized investment management. NEST participants have personal accounts, but they don't manage them directly. The default investment is a target date fund made up of five or six underlying funds. NEST hired Tata Consultancy Services, the India-based global IT firm, to administer the plan. State Street Global Advisors has a 10-year contract to administer the investment funds. The managers of the underlying funds are State Street, BlackRock, UBS, HSBC, F&C Investments, and Royal London Asset Management.

Target date funds with big differences. There are 45 different target date funds in NEST, one for each year that participants will retire. (In the U.S., of course, target-date funds are dated in five-year intervals.) The organizers of NEST intend to manage the funds very conservatively. Unlike target date funds in the U.S., where the equity allocation tends to be very high in the early years and to remain substantial even after retirement, NEST TDFs owned by 20-somethings will be highly conservative at the beginning, and will hold zero equities at the retirement date. Each account will go through three phases: a cash-preservation Foundation phase that lasts for up to five years, a long Growth phase, and then a Consolidation phase that starts about 10 years before retirement. The lines between phases may blur, because fund managers will actively manage asset allocations to avoid adverse timing.

Ultra-low fees. The ongoing all-in investment and administration fee load for NEST participants is only 30 basis points. For the first few years, participants will pay a 1.8% front-end load to help reimburse the

British Treasury for lending NEST its startup funds.

A different audience. The typical NEST participant is expected to be under age 35 and earning the equivalent of about $27,000 a year. Members of ethnic minorities will represent a large percentage. Most have little knowledge of saving or investing and NEST's own surveys show that 37% are risk-averse. Many are excluded from participating in their employer's private DC plan. In the U.S., 401(k) anti-discrimination regulations require plan sponsors to ensure that coverage is universal and participation is broad-based. The U.K. has no anti-discrimination laws that apply to DC plans. The NEST target audience has a counterpart in the U.S., however: the millions of American workers who have no access to an employer-sponsored retirement plan.

Next week: How NEST came to be, how it invests participants' money, and why corresponding efforts in the U.S. haven't made much progress.