Lifetime ISA

July 2017
A report by the SMF
for Scottish Friendly

Scottish Friendly

Executive Summary

Under-saving in the UK

Helping young people build up medium-term and long-term savings is imperative: making households financially resilient and less likely to fall back on the state, enabling them to achieve important life goals and assisting them in preparing ahead for retirement.

However, the UK's savings record is poor and particularly stark amongst younger people:

- The household savings ratio was at 1.7% in Quarter 1 2017, the lowest since records began in 1963.
- Analysis of the 2012/14 Wealth and Assets Survey shows that less than half of those aged under-40 have saved in the last two years.
- Our consumer survey found that, for those under 40, seven in ten either know they are not saving enough for retirement or are not confident that they are doing so, while only 17% believe they are saving enough.

The potential of the Lifetime ISA

The report argues that the Lifetime ISA presents an opportunity to help address this under-saving, to help young people achieve their life goals and long-term financial aspirations.

- The twin purposes of the LISA (owning a home and saving for retirement) are popular aspirations for those under 40, and an advantage of the LISA is that these goals can be pursued within one product. Of those surveyed, 70% stated that saving for a home was a priority for now or the future, whilst 68% thought the same for 'saving for retirement'.
- Using the ISA brand may help make savings easier and more attractive. Our survey suggests that ISAs appear to enjoy a 'simplicity premium' over pension products, with individuals finding the concept of the ISA easier to understand than other alternative products: 84% of respondents gave ISAs a ranking of 3 or above out of 5 (with 1 difficult to understand and 5 simple); whilst 69% of individuals gave pension products a ranking of 3 or above.
- When offered a description of the LISA's features, seven in ten either reported an interest in opening an account or had already opened an account. Of those individuals who said they had already opened an account or might in the future use the LISA two thirds (66%) of respondents cited the government bonus as the product feature they found appealing; whilst 44% cited the flexibility of the product.

The report argues that the Lifetime ISA presents an opportunity to help address this under-saving, to help young people achieve their life goals and long-term financial aspirations.

The report also argues that the LISA could promote choice and competition in the retirement savings market, coming off the back of past concern about value for money in the pensions market. Our survey suggests that consumers are better informed about the ISA market than the pension market. Of those who hold products, 22% of respondents report knowing their ISA charges compared with 8% their pension charges.

Existing design flaws in the LISA

Notwithstanding this potential, specific features of the LISA product mean that it remains a sub-optimal retirement savings vehicle for many, and we risk missing an important opportunity to help younger people build up their savings and achieve their financial goals.

- Employees who put money aside for their retirement through a LISA are losing out on significant sums of employer contributions that would have been made if they had saved through a pension. We estimate that an employee could lose out on £19,618 by the age of 50. Within our research, 37% of respondents stated that they would be more likely to use the LISA if employer contributions were included. This figure rises to 47% of those who are employed full-time.

- Savers who put money aside into a LISA may find their eligibility to means-tested benefits reduced in ways that wouldn't occur if they saved through a traditional pension. As it is, capital rules mean that those with more than £16,000 of savings become ineligible to receive means-tested benefits such as Universal Credit. Pension savings are exempted from this means-test assessment, but LISA savings are included. Our analysis of the Wealth and Assets Survey finds that half (49%) of individuals aged 35 to 39 would have saving levels above the threshold for mean-tested benefits.

- There is a risk that LISA savers will opt for more conservative investment strategies than is typically the case for an average pension fund, undermining their long-term returns.

- There are also potential issues relating to when savers can access their savings and the withdrawal penalty.

Re-designing the LISA

The report puts forward recommendations to help enable the LISA to be a beneficial new savings policy. We recommend that:

- The Government should ensure that those who save through a LISA are equally able to benefit from employer contributions as those who save through a pension.

- The Government should permit LISA products to be used as compliant auto-enrolment savings products. It should also ensure that these products adhere to the rules on charges.

- LISA savings should be exempted from the capital rules for means-tested benefits and support.

- The Government should keep a watching brief of market developments in terms of investment strategies and consumer behaviours.

- The Government should keep the withdrawal penalty and assess over time whether it needs to be higher if many young people withdraw money for purposes for which the product was not designed.

- The age at which LISA savers can access their money for retirement purposes should be equalised with the rules for accessing a pension, namely be brought forward from 60 to 55.

- The Government should remove the age restrictions, allowing savers over the age of 40 to open a LISA and continue to contribute past the age of 50.

Introduction

The Lifetime ISA (LISA) is a tax-incentivised means of saving for retirement and for buying a first home. It was announced in the Spring Budget of 2016, legislated for through the Savings (Government Contributions) Act 2017 and available in the market from April 2017.

How the Lifetime ISA works

The Lifetime ISA (LISA) sits alongside traditional cash ISAs and stocks and shares ISAs, the Help to Buy ISA and the new Innovative Finance ISA (for peer to peer lending and crowd funding).[i]

The LISA has unique features. In a LISA, savers receive a flat rate of government contribution, and savings are exempt from tax upon withdrawal, subject to key conditions. Adults aged under 40 can open a LISA to save to buy their first home or for retirement. Individuals can put in up to £4,000 each year, until they are 50. The government will add a 25% bonus to the individual's contributions, up to a maximum of £1,000 per year. The savings can be held in cash, stocks and shares or a mix. There's a 25% charge to withdraw cash or assets from a Lifetime ISA unless the money is taken out to buy a first home or taken out after age 60.[ii]

The Government's motivation when introducing the LISA was to 'help young people save flexibly for the long-term throughout their lives', and to 'simultaneously save for a first home and for their retirement, without having to choose one over the other'. It aimed to harness the advantages and simplicity of the existing ISA products.[iii] The Government estimated that 800,000 individuals would be saving into a LISA by 2020-21.[iv] The Treasury estimated that the introduction of the LISA would cost an additional £830m

Explaining pension auto-enrolment

Auto-enrolment (AE) was introduced through the Pensions Act 2008. Employers must automatically enrol eligible workers into a qualifying pension scheme unless the employee is already saving in this way. Qualifying employees are aged between 22 and state pension age and earn more than £10,000. Unless the worker opts out, the employer must make contributions. Once fully in place, at least 8% of wages will be saved into the pension (4% from the worker, 3% from the employer and 1% from the government via tax relief). Minimum contribution rates are rising gradually over time to this level. As of April 2017, half a million employers are signed up to the scheme.[vii]

So far, more than 8million workers are saving through AE[viii], with the Government expecting over 10 million people newly saving or saving more by 2020.[ix] The Government is reviewing the AE policy with a view to publishing reforms in 2017.

In its Impact Assessment of the LISA, the Government estimates of take-up of the new product did not assume that any individuals stop contributing to workplace pension schemes to save into a LISA. However, the Treasury did assume that some individuals would choose not to save into a pension and save into the LISA instead.[x]

by 2020-21. As the OBR, this estimate is 'very uncertain' and is very sensitive to the behavioural response of consumers: whether they are more likely to save, whether they save more in total and how they withdraw the money.[v]

The introduction of a new product into the market with these features has a potentially transformative impact. It could drive higher savings levels among young people, help them achieve their medium and long-term financial goals and increase competition in the market.

However, existing product features mean that the LISA is unlikely to achieve these objectives. Some product aspects remain incomplete and sub-optimal. Meanwhile, it is being introduced alongside other savings initiatives including auto-enrolment into workplace pensions, and its fit with such schemes is unclear. Thus far, attention has focused on the disbenefits of the LISA as a competitor to traditional pension schemes. For instance, the Work and Pensions Select Committee concluded that 'the introduction of the Lifetime ISA, potentially seen as a competitor product, could jeopardise the success of AE.'[vi] But, we would be better focusing on the potential benefits.

In addition, we observe that the current savings policy landscape, including the tax relief options available to savers is extremely complex, and that there may be benefits over time in simplifying this.

This report

This research seeks to assess the potential benefits of a product like the LISA and analyse how the LISA could be re-designed so that these benefits can be achieved. It answers three main questions:

- What are the potential benefits of a product like the Lifetime ISA?
- What are the problems with its current design including for retirement purposes and in terms of flexibility?
- How could we re-design the LISA to better help younger consumers achieve their medium and long-term goals?

Methods

This report is based on original analysis of the ONS's Wealth and Assets Survey (2012-14), as well as a specially-commissioned poll of 2,000 UK adults aged under-40 carried out between 9th and 16th June 2017 by 3Gem. The survey is representative by gender and region. The research also draws on other government publications and reports by other think tanks.

Part 1: Potential benefits of a well-designed Lifetime ISA

1. Increasing savings among younger adults

Increasing the level of savings across the UK population and particularly amongst the younger population is a crucial agenda for the UK government, suggesting a potentially important role for the LISA.

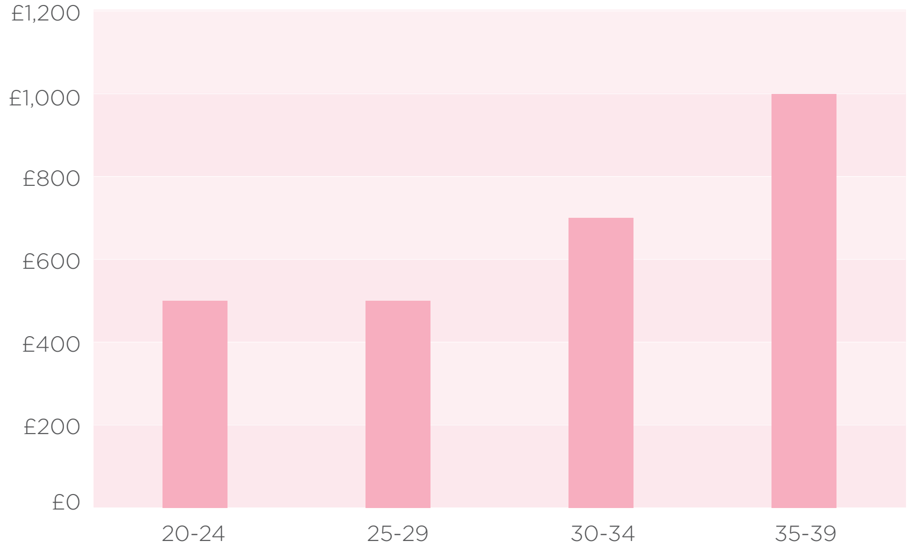
Why we need to increase savings levels

Building up medium-term and long-term savings from an early age is imperative: making households financially resilient and less likely to fall back on the state, enabling them to achieve important life goals and helping them prepare ahead for retirement. In particular, saving early can allow investors to benefit from compound interest over a number of decades.

However, the current savings landscape within the UK is bleak. For some time, the country has had one of the lowest levels of savings as a percentage of GDP amongst advanced economies.[xi] The household savings ratio, which measures how much people are saving out of their disposable income, was at 1.7% in Q1 2017.[xii] This is the lowest it has been since records began in 1963.

The picture for those aged under-40 is no less stark across both cash savings and pension savings. The Treasury reported that 82% of ISA holders are aged over 35.[xiii] Analysis from the 2012/14 Wealth and Assets Survey (WAS) reveals that fewer than half of those aged under-40 have saved in the last two years. Analysis of the WAS also shows that the majority of those under 40 do not have a savings account, with two-thirds of those aged 20 to 24 not having a savings account. Whilst holding a savings account suggests positive savings behaviour, many accounts hold only nominal sums. Among individuals who hold a savings account the median value of savings is £700, this falls to £500 for those aged 20 to 29, with a quarter of this age group having £40 or less within their savings. The median amount saved is £1,000 for those aged 35 to 39, with a quarter of savers in this age group having £100 or less. While this conforms to our expectation of lifecycle saving (i.e. that people build up larger stocks of assets during their working lives), the values are very modest.

Figure 1: Median value of savings by age:

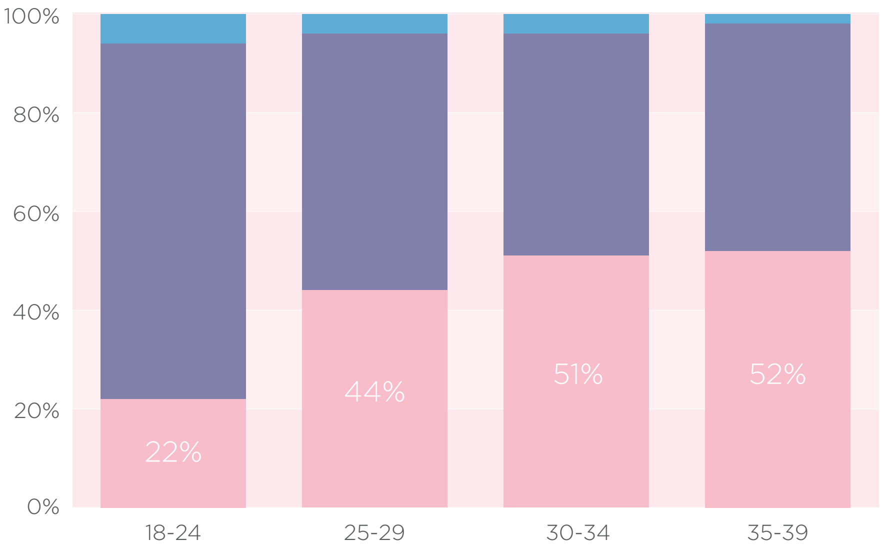


Source: Wealth and Assets Survey 2012/14. Base: those who own saving accounts

Turning to retirement savings, a similar picture emerges. Estimating participation in pensions is currently difficult given the roll-out of automatic enrolment (AE). Due to the introduction of AE, the Wealth and Assets Survey is likely to underestimate the number of people under 40 who are saving for retirement. By 2020, an estimated 10 million workers will be newly saving or saving more for retirement because of auto enrolment;[xiv] and over half the eligible AE population is aged under 40.[xv]

As it is, our consumer survey shows that four in ten of those aged under 40 have a pension. This masks considerable variation by age: more than half of those over 30 have a pension compared to 22% of those aged 18 to 24. Of those who have a pension, 87% are currently contributing.

Figure 2: Response to "Do you have a pension?"

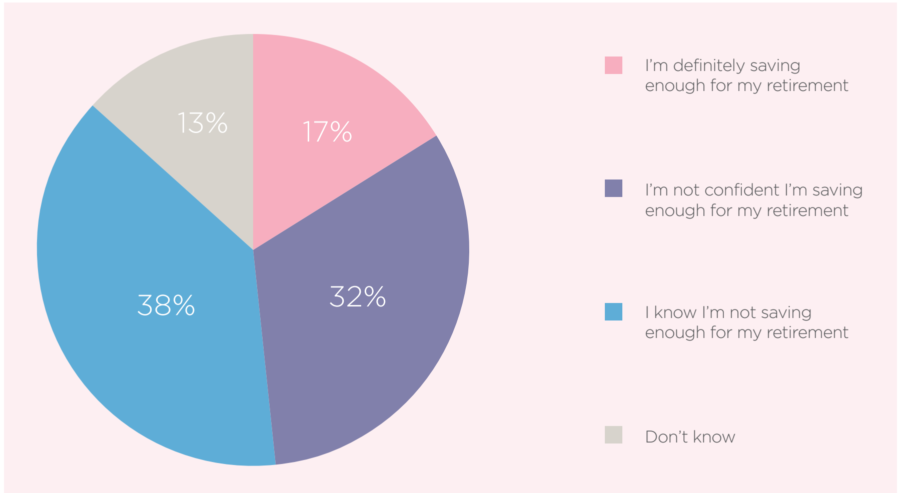


Source: SMF analysis of 3gem polling. Base: all respondents

This divergence across age is likely to at least partly reflect individuals' current labour market status. If we focus on those who work full-time aged under 40, nearly two thirds (63%) have access to a pension, including half (50%) of those working full-time aged 18 to 24. This compares to only 34% of those under 40 who are part-time workers.

Our survey also asked respondents whether they think they are saving enough for retirement.

Figure 3: Response to 'Do you think you are saving enough for your retirement?'



Source: SMF analysis of 3gem polling. Base: all respondents

Our research found that for those under 40, seven in ten either know they are not saving enough for retirement or are not confident that they are doing so, while only 17% believe they are saving enough. It is noticeable that even among those in the highest socio-economic group (AB) only one in three believed they were saving enough.

Why the LISA might help increase savings levels

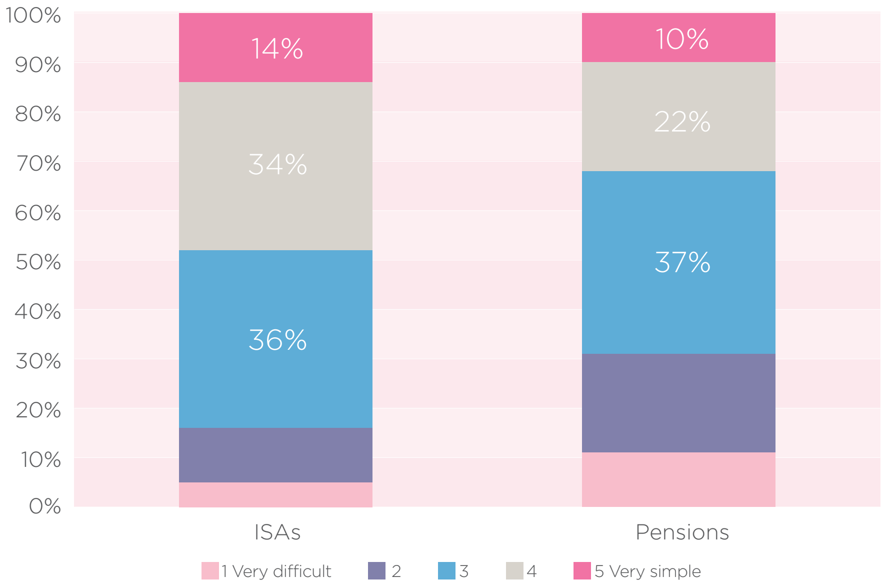
Against this depressing backdrop, there are a number of reasons to anticipate that a product like the LISA could increase the attractiveness of savings.

First, Individual Saving Accounts (ISAs) are a comparatively popular savings vehicle. Our polling shows that nearly half (47%) of our sample hold at least one type of ISA. This is slightly higher than the proportion that is registered in the WAS – this may be accounted for by an increase in take-up of ISAs in the intervening years, the introduction of the Help-to-Buy ISA and different sampling techniques. While ISA products (as with all savings products) are more common among higher-income groups, it is noteworthy that in our survey 31% of those who earn under £15,000 have any form of ISA, this compares to 67% of those who earn over £50,000.

Second, separate research from the SMF has shown that ISAs are a popular saving device and that this may derive in part from the importance of timely information about products during the decision-making process. For instance, the visibility of ISAs and the annual marketing cycles may prompt people to save through ISAs.[xvi]

Third, individuals tend to find the concept of the ISA simpler than other alternative products. All other things being equal, we may therefore expect consumers to be more ready to save into such vehicles than in other products (such as traditional pensions or non-ISA products). In our consumer polling, we asked individuals how simple ISAs are to understand and use. This involved a scale from 1 to 5, with 1 being very difficult and 5 being very simple. In response, 84% of respondents gave a ranking 3 or above. Respondents were asked the same question of pension products: 69% of individuals gave a ranking of three or above. Nearly half of consumers (48%) scored ISAs as 4 or 5; compared to a third (32%) scoring pensions as 4 or 5. ISAs, therefore, appear to enjoy a 'simplicity premium' over pension products.

Figure 4: Responses to "How simple do you think ISAs/Pensions are to understand and use?"



Source: SMF analysis of 3gem polling. Base: all respondents

As Figure 8 shows, the government bonus is viewed very positively by consumers as a reason to save through a LISA. Separately research has suggested that tax relief through pensions is not an effective incentive.[xvii]

2. Meeting the needs and ambitions of those under 40

Previous research has shown that millennials have a wide range of financial goals.[xviii] When the LISA was introduced, the Government set out two savings priorities for the LISA: the ability to save for a deposit for a first home and for retirement.

Owning a home and ensuring savings produce adequate income in retirement are important goals for those under 40. This is because homeownership remains a popular concept and an important route to building up assets over a lifetime; whilst retirement savings are needed to achieve an adequate income in later life. This is underscored below through our commentary as well as by consumer attitudes.

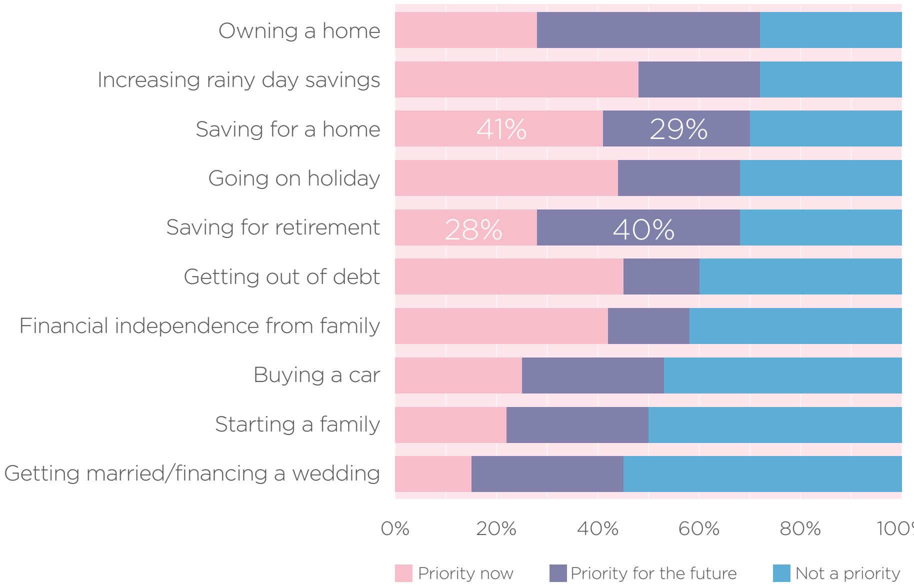
The cost of housing has increased significantly in recent decades. At the same time, borrowing requirements have become stricter following the financial crash. The consequence is that individuals need to build up significant sums for a deposit if they wish to buy a home.[xix] On average, working people could expect to pay around 7.6 times their annual earning in order to purchase a home in England and Wales in 2016, and this is up from 3.6 in 1997.[xx] In 2013/14, 36% of those aged 25 to 34 owned a home compared to 60% in 2001/02.

Meanwhile, saving for a retirement is increasingly becoming the responsibility of the individual rather than their employer. The generation now approaching retirement are likely to have Defined Benefit (DB) pensions. Younger generations (unless they work in the public sector) are almost all on Defined Contribution (DC) pension schemes. DC schemes rely on individuals saving for their own retirement; and employer contributions to DC schemes are much lower than employer contributions to DB schemes.[xxi] It is also important in DC schemes to save early in a career as this allows for the value of the investment to grow over an extended period of time.

Our research shows that increasing the level of rainy day saving is the highest 'current' priority for those under 40. Getting out of debt is the second highest priority and is likely to significantly affect the ability of young people to save. Evidence suggests that consumer credit has experienced rapid growth in the last 12 months, and this is likely to influence saving priorities and affect where savers choose to put their discretionary income.[xxii]

However, when we look at 'current and future' priorities, owning a home is the highest priority, closely followed by rainy day savings. Of those surveyed, 70% stated that saving for a home was a priority for now or the future. This figure would be higher if we look at the responses of non-homeowners.[xxiii]

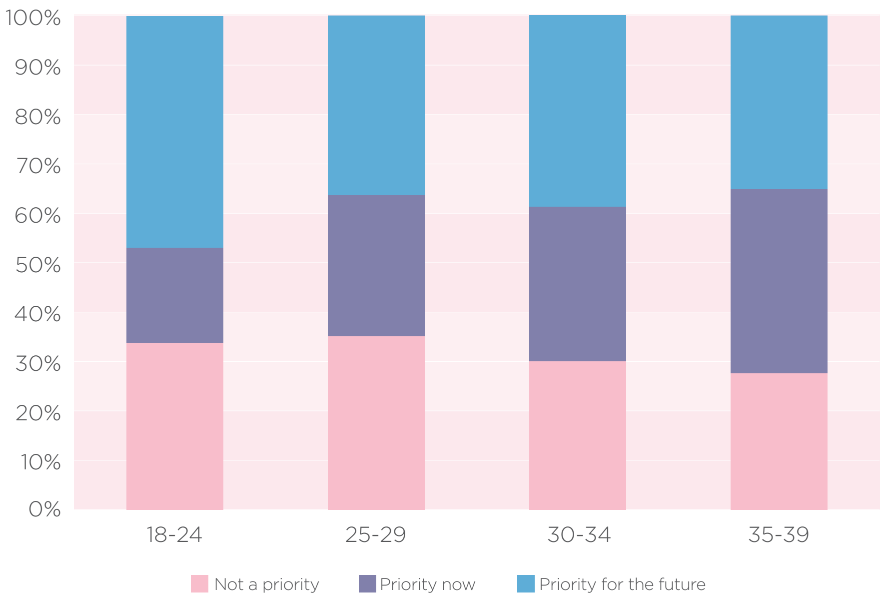
Figure 5: Current and future priorities of those under 40



Source: SMF analysis of 3gem polling. Base: all respondents

Saving for retirement is also a high priority (equal with saving for a holiday). While a lower proportion view saving for retirement as a current priority, 40% believe it is a priority for the future. Age influences the time horizon over which retirement saving is a priority, with 19% of those aged 20 to 24 stating it is a priority for now compared to 37% for those aged 35 to 39. This is likely to reflect life stage and career stage as well as affordability. The introduction of automatic enrolment means that, whilst individuals may not believe this is a priority, it is possible they are saving for retirement without being fully aware.

Figure 6: Attitudes toward retirement saving by age



Source: SMF analysis of 3gem polling. Base: all respondents

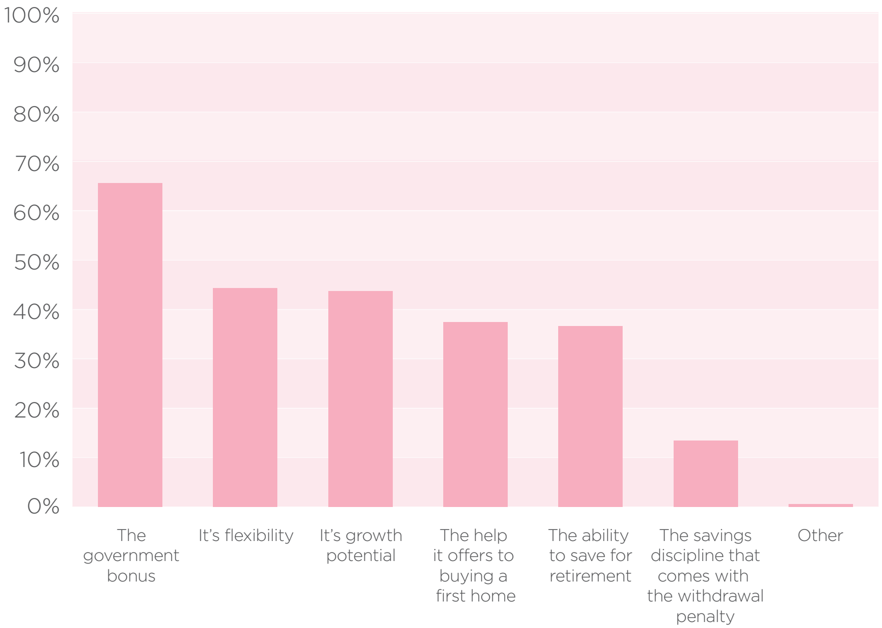
Why the LISA might help young people achieve medium and long-term goals

Our survey suggests that the ISA could potentially help young adults achieve these medium and long-term goals.

Within our sample awareness and take-up of the LISA is comparatively low. This is unsurprising given the fact that the product has only recently been made available whilst only a small number of providers are offering the product. Our research showed that 50% have heard of the Lifetime ISA. Once we described the features of the LISA, we asked people to state whether they intend to open a LISA: 61% stated they may in the future and 10% declared that they have already done so, the remaining were unsure or had no intention of doing so. This suggests that seven in ten of those in our sample would be ready to use a LISA. There is also evidence to suggest that the LISA appeals to those who do not usually save, six in ten (62%) of those who earn under £15,000 per annum state they have already opened a LISA or have intentions to do so.

More specifically, the survey asked those individuals who said they had already or might in the future use the LISA which product features they found appealing. Two thirds (66%) of respondents cited the government bonus. The next most popular answer was the flexibility cited by 44% of respondents. These findings were relatively even across income groups.

Figure 7: What features do you like in this product?



Source: SMF analysis of 3gem polling. Base: those who have opened/have intentions of opening a LISA

3. Increasing competition within the market

A third reason why the LISA could benefit savers is the effect it could have on the market and competition.

Historically there have been concerns around value for money in the pension product market. In its 2013 study, the Office of Fair Trading concluded that competition alone would not drive value, due to weaknesses on the buyer size of the market and the complexities of the product.[xxiv] Problems with transparency of charges and comparability of prices and products have also been cited as particularly problematic. For instance, a 2013 DWP consultation cited concerns about members who no-longer make contributions having to pay a deferred member charge.[xxv]

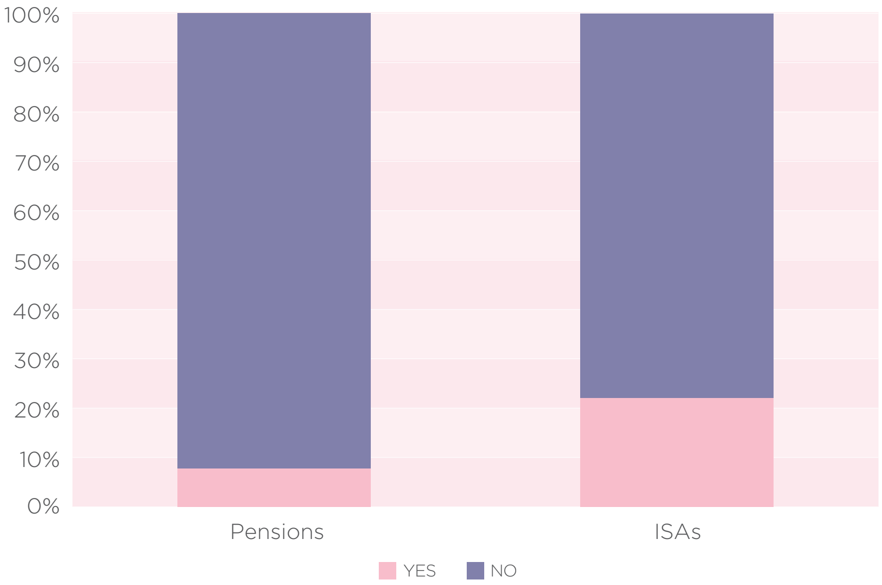
Because of these findings, and the introduction of the quasi-mandatory AE policy, the government opted to introduce a charge cap. Schemes used by employers participating in AE must keep annual fees below 0.75% of funds under management.[xxvi] There have also been efforts to improve the role of independent governance in pension schemes. In 2016, the Chancellor announced a new duty on the FCA to cap early exit charges in certain pension contracts.[xxvii] Alongside concerns about management charges, the FCA's review of asset management concluded that price competition is weak and profits are high.[xxviii]

Why the LISA might help drive more competition and better value savings products

The introduction of a new and innovative product within the market has the potential to increase competition, drive wider choice, increase innovation and lower costs for consumers.

Due to greater simplicity (see survey results above), an ISA product may facilitate greater engagement and allow consumers to choose the most suitable and best value product more easily. This may have the effect of driving more competitive rates across the ISA and pension product markets. Specifically, our polling indicates that consumers are more aware of the charges on ISA products compared to pension products. Figure 8 illustrates the difference with 22% knowing their ISA charges and 8% their pension charges. Notable also is the low proportion of consumers across all product categories who are aware of the charges. This suggests that, while the availability of the LISA product may drive greater competition in the market, more needs to be done to promote transparency and consumer awareness of charges across the board.

Figure 8: Proportion of product holders who reported being aware of product charges



Source: SMF analysis of 3gem polling. Base: respondents who hold an ISA/pension

Summary

This section has shown that the introduction of a LISA could potentially have significant benefits for individuals, boost the financial resilience of individuals and drive competition in the market.

Part 2: Assessing the extent to which the current LISA allows these benefits to be achieved:

Part 1 described the potential benefits for savers that could arise following the introduction of the LISA. However, as this section sets out, the current design of the product means these benefits may not be achieved. Below we set out four areas where policy needs to be re-designed.

Design challenge 1: Loss of employer contributions:

Employees who put money aside for their retirement through a LISA are losing out on significant sums of employer contributions that would have been made if they had saved through a pension.

Under AE, employers are compelled to offer a pension to their employees. Currently, minimum employer contributions to DC pensions are being stepped up in stages from 1% of wages (2017), to 2% (2018) and to 3% (2019). Once fully rolled out from April 2019, employers must contribute at least 3% of salary to an employee's pension scheme with the government contributing 1% (via tax relief) and the employee contributing 4%.

Employees who save through a LISA rather than a pension scheme for their retirement could therefore forego significant contributions from their employers. As the FCA noted in its policy paper on LISAs, 'We acknowledge there may be circumstances where a retail client is saving into a personal pension plan to which their employer contributes, and that choosing to save into a LISA in preference to such a scheme might cause that consumer to forfeit employer contributions to that scheme.[xxix] Therefore, the FCA's guidance requires providers to provide a risk warning: 'making it clear that investors may also lose out on employer's pension contributions where they have a personal pension and there is an employer matching contribution structure in place'.[xxx] This problem does not arise for self-employed workers who have no employer to make contributions.

Although in a perfectly-functioning market we would expect individuals who receive pension contributions from their employers to receive a lower wage, this is not evident in practice. As such, it is likely that many workers will simply forego employer contributions. Our survey shows that a significant proportion of consumers attracted to the LISA showed a desire to use it to save for retirement (51%). Such individuals will end up with lower retirement pots if they saved through a LISA as currently designed as compared with a traditional pension product.

Table 1 below illustrates the annual amount of employer contributions foregone by the employee when saving through the current LISA compared with a traditional pension product. The minimum employer contributions are set on earnings over £113 per week up to an upper limit of £866 per week.[xxxi]

Table 1: Annual value of missed employer contributions

Age	Median annual salary*	Annual value of employer contributions at 3%
18 to 21	£16,364	£314.65
22 to 29	£23,197	£519.64
30 to 39	£29,780	£717.13

* Based on Annual Survey of Hours and Earnings (Median weekly multiplied by 52) midpoint between male and female taken.

For those aged 18 to 21 the amount lost is £315 per year. By the time this individual reaches retirement age the difference between what they have in their LISA and what they would have had in their pension will be significant. If we assume a median income saver substitutes their pension for a LISA from the age of 22 to 50, the total amount lost in employer contributions is £19,618**. This represents a huge sum sacrificed, and whilst the tax treatment upon withdrawing savings at retirement is different across the two products, we do not anticipate that the tax saving would be larger than the foregone employer contributions. Indeed, this figure is likely to underestimate the total amount due to cautious assumptions, including 2% investment return and no wage growth in the economy. We would also expect average contributions to climb above 3% once the AE scheme is fully operational and for many employers to contribute more than the 3% minimum.

Before the policy was introduced, average employer contributions were significantly higher.

It should be noted that higher-rate taxpayers could also forego their higher rate of tax relief when saving through a LISA compared with a pension as indicated in Table 2. Successive chancellors have threatened to amend the tax relief regime. It is likely there would be a trade-off between the advantages of the simplicity of the flat rate bonus in the LISA versus an incentive structure that benefits all savers. In addition it might be noted that most commentators agree that a disproportionate amount of savings incentives already go to higher earners.

Table 2: Lifetime ISA compared to a pension pot (CPS)[xxxii]

		Pension pot*			
	Lifetime ISA	**20%/20%**	**20%/40%**	**40%/20%**	**40%/40%**
Post-tax contribution	£800	£800	£800	£800	£800
25% bonus	£200	–	–	–	–
Tax relief	–	£200	£200	£533	£533
Sum at retirement	£1,000	£1,000	£1,000	£1,333	£1,333
25% tax-free lump sum	–	£250	£250	£333	£333
Income tax in retirement	£0	-£150	-£300	-£200	-£400
Post-tax outcome	£1,000	£850	£700	£1,133	£933
% uplift on initial contribution	25.0%	6.3%	-12.5%	41.6%	16.6%

* Income Tax when working/Income Tax in retirement

** This figure is calculated based on previously mentioned median earnings, with 3% employer contributions and assumed 2% investment return.

Design challenge 2: Means-tested benefits:

Savers who put money aside into a LISA may find their eligibility to means-tested benefits reduced in ways that wouldn't occur if they saved through a traditional pension.

When applying for benefits such as Universal Credit (including Housing Benefit and means-tested Job Seeker's Allowance) capital rules mean that individuals with savings worth more than £16,000 are ineligible to receive support. Those with between £6,000 and £16,000 are eligible to a lower level of support than those without any capital.

Currently pension wealth is excluded from the capital allowance for individuals under the qualifying age for Pension Credit.[xxxiii] This means that an individual can accumulate savings for their retirement without sacrificing their eligibility to means-tested benefits during working age.

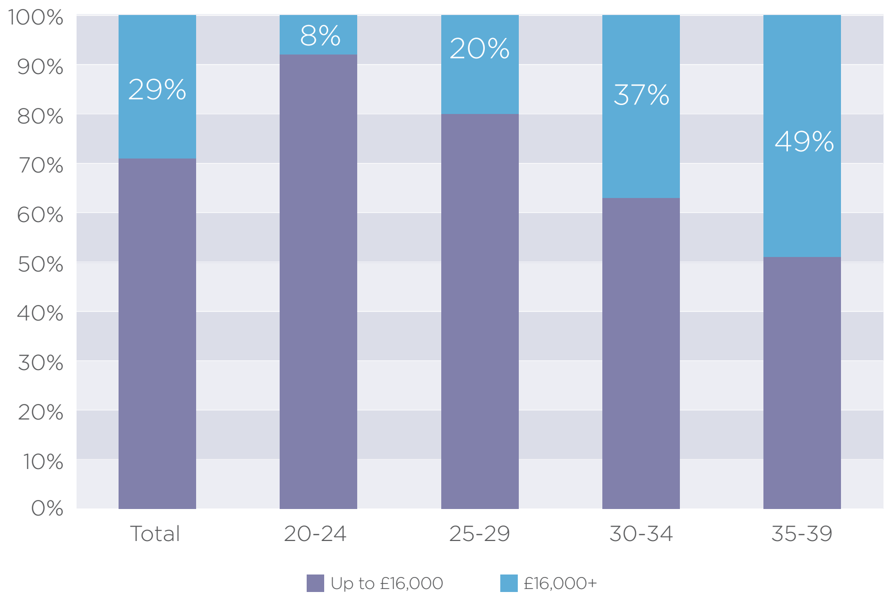
However, the same principle does not apply to individuals who opt to save for retirement in the LISA. Individuals with more than £16,000 in savings would find themselves ineligible for support. LISAs are therefore treated like other ISAs and saving products. In this situation, some may find themselves having to withdraw money from their LISA, thus incurring a penalty. The FCA requires LISA products to carry a 'warning [to] investors to consider the impact of taking out a LISA on means-tested state benefit'.[xxxiv]

Means-tested benefits and capital rules

Means-tested benefits (e.g. Universal Credit) for working age individuals have a lower capital limit of £6,000 and an upper limit of £16,000. The lower limit is higher (£10,000) for care and nursing home residents. £1 per week income is assumed for each £250 above this. For those above the State Pension Age, for Pension Credit, the first £10,000 is ignored. £1 per week income is assumed for each £500 above this. There is no upper capital limit.[xxxv]

Our analysis indicates that many could find themselves affected. Analysis of the Wealth and Assets Survey shows that 10% of individuals have financial (non-pension) wealth over £16,000, ranging from 4% of those aged 20 to 24 and 17% for those 30 to 39. Such individuals are unable to claim means-tested benefits. However, many more individuals would be affected if pension wealth was also captured in the capital allowance, increasing the proportion of individuals with savings above £16,000 from 10% to 29%. It is notable that half (49%) of individuals aged 35 to 39 would have saving levels above the threshold for mean-tested benefits during their working life. In addition to those individuals ineligible for support due to the £16,000 threshold, others with savings between £6,000 and £16,000 would have lower entitlement. Those beyond the State Pension Age are likely to find themselves more likely to be caught in the social care means test.

Figure 9: Financial and Pension wealth by age



Source: Wealth and Assets Survey 2012/14. Base: all respondents

In summary, our research suggests that the current design of the LISA could leave many individuals ineligible for means-tested support simply because they are saving for their retirement through a LISA rather than a pension.

Design challenge 3: Withdrawal terms and penalties

Savers face a 25% charge on withdrawals from the LISA unless money is taken to buy a first home or after the age of 60. Savers may be hit if they are using the product for short-term saving and may not face a significant enough disincentive to stop them dipping into their retirement savings.

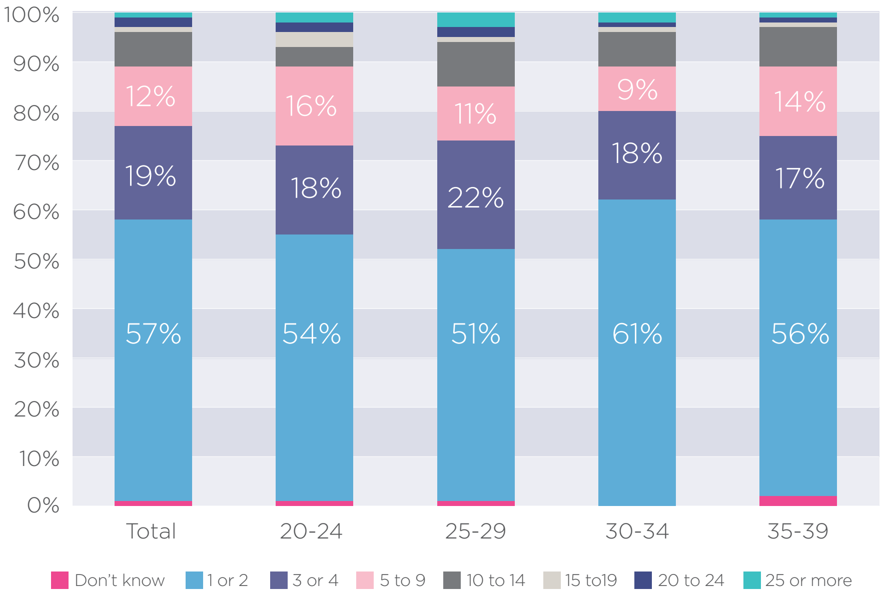
The Lifetime ISA was designed to help savers realise their goals of homeownership and help them save for retirement. Because of the product design if savings are removed for any reason other than for homeownership or before the age of 60 they are subject to a 25% penalty on the amount withdrawn. The withdrawal penalty is equivalent to a 6.25% reduction in the amount contributed by the saver.[xxxvi] The saver therefore loses the initial government bonus and more. There has been considerable discussion about whether the withdrawal penalties are appropriate.

Table 3: Example impact of the early withdrawal charge (FCA) [xxxvii]

LISA Consumer actions	Year 1	Year 2
A Consumer subscription	£4,000	
B Government bonus (25%)	£1,000	
C Total for year 1	£5,000	
D Consumer early withdrawal		£5,000
E Government charge (25%)		-£1,250
F Consumer receives		£3,750
Consumer loss of capital (F-A)		-£250

Analysis from the Wealth and Assets survey allows us to understand the current withdrawal behaviour of ISA savers. Research suggests that 37% of ISA savers withdrew money from their ISA savings within the last two years. The majority of savers only withdrew from their ISA once or twice, but 12% withdrew money between five to nine times. The amounts withdrawn by savers tend to vary, with one third withdrawing less than £1,000.

Figure 10: Frequency of ISA withdrawals



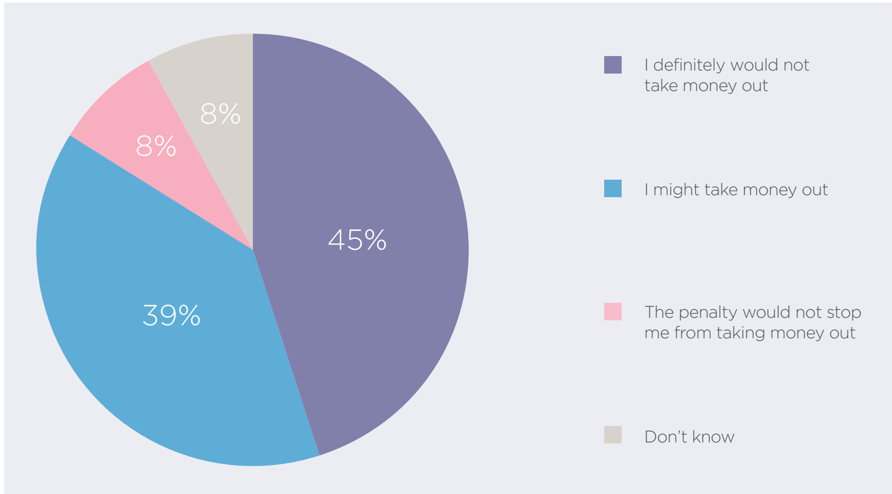
Source: Wealth and Assets Survey 2012/14. Base: those who have withdrawn from ISA

The analysis above suggests that if savers do not adjust their behaviour when saving within a LISA they would lose a significant proportion of their savings. Absolute clarity is needed therefore on the purpose of the LISA as compared with more flexible and accessible tax-advantaged ways of saving. The FCA's guidance requires that providers issue risk warnings to consumers to advise them of the penalties ahead of investing.

The views of consumers themselves on the withdrawal penalty are mixed. In our sample, 13% of those who were interested in the Lifetime ISA stated that they like the savings discipline that comes with the withdrawal penalty, whereas a third of those who were not interested in the product stated that the penalty put them off.

As Figure 11 reveals, of those who are interested in the Lifetime ISA, fewer than half of individuals believe that the withdrawal penalty is enough to stop them taking money out of their account. The proportion who would not take money out does not vary significantly by age and neither does the proportion of individuals who believe the penalty is not enough to stop them withdrawing their savings. This evidence suggests that consumers are unlikely to save and behave in a way that is rational and optimal.

Figure 11: Attitudes towards the withdrawal penalty



Source: SMF analysis of 3gem polling. Base: those interested in the Lifetime ISA

There is a trade-off between making a savings product attractive to savers versus ensuring that the policy objectives for which it is designed are achieved. For instance, early access to pension products is penalised with a 55% charge.[xxxviii] Pensions could be made more attractive by removing this charge, but then society's goal of bolstering retirement incomes would be undermined. At the very least, the taxpayer will want to ensure that any subsidy that the saver enjoys is recouped if the money is not used for the one of the purposes that the government intended. The same trade-off applies for the LISA. As Michael Johnson has noted, experiences elsewhere suggests that caution is recommended. US savers can 'borrow' money from their 401(k) plans ahead of retirement. But, the result is that many reach retirement with net liabilities.[xxxix]

Separately, there is a question over when ISA products and funds should be available. For pension products, individuals can access their funds at age 55 following the pension freedom reforms. It is not clear why money held in a LISA is available only from age 60. Equally, LISA savers are not allowed to contribute to their LISA after the age of 50, whereas this restriction does not apply to pension savers.

Design Challenge 4: Investment choices:

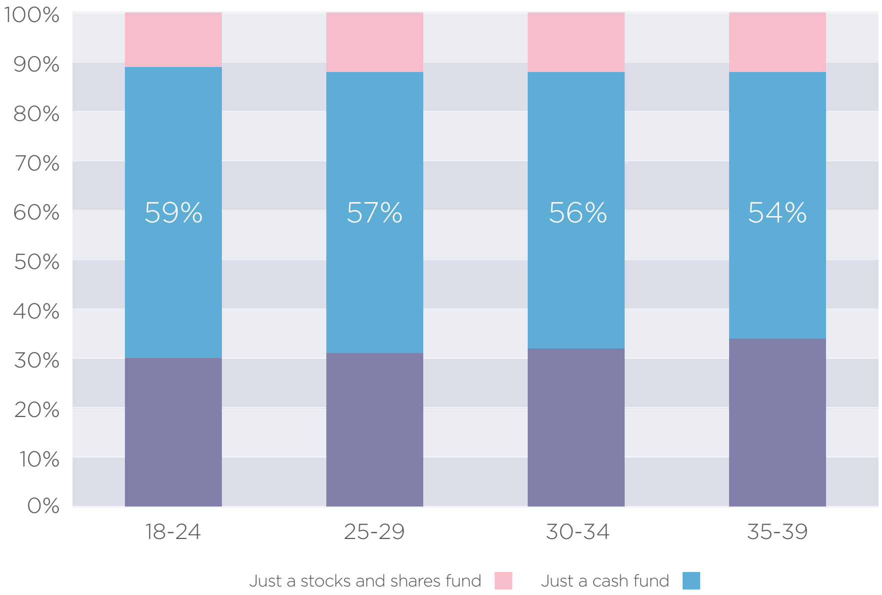
Savers may display risk-aversion in their investment choices thus undermining their long-term yields.

The LISA could potentially put greater decision-making power in the hands of consumers. This could be beneficial for competition and for ensuring that consumers get the most appropriate product for them.

However, there is a risk that individuals will make sub-optimal decisions on investment risk. This is particularly problematic in the context of many individuals using the LISA as a mechanism to save for retirement over 20 or 30 years. Analysis conducted by Schroders in early 2017 shows that a saver who placed £1,000 into a Cash ISA when they launched in 1999 would have £1,204 today, this is much lower than the £1,663 they would have if they opted for a stocks and shares ISA.[xl] In addition, as the FCA noted, savers will need to make multiple investment strategies if they have multiple savings objectives in the same product. If they buy a home, they may not alter their existing investment strategy and remain in inappropriate assets.[xli]

We know that consumers tend to favour cash savings. Within our research, 86% of those who had an ISA had a cash product; this is significantly higher than the 27% who opted to save in a stocks and shares product. When saving for short or medium term goals cash can be the best option,[xlii] however for goals with longer-time horizons, such as retirement, investing in equities and higher risk assets typically delivers a much higher yield. The disparity between consumer behaviour and optimal asset allocation is evident also in the investment strategies of those in our survey who reported interest in using the LISA to save for retirement. Figure 12 shows that a majority of those who would save for retirement through a LISA would opt for a cash fund, and only a minority would opt for a stocks and shares fund or a mix.

Figure 12: Savings method for retirement



Source: SMF analysis of 3gem polling. Base: those who would save for retirement in the Lifetime ISA.

Past research from the SMF has also shown that the product 'wrapper' matters. For instance, consumers perceive pension products to be lower risk than stocks and shares ISAs, as well as than other share products. This is despite the fact that pension funds hold large shares of equity investments.[xliii] Consumers also perceive stocks and shares ISAs to be lower risk than investing in shares separately.

Finally, the Pensions Policy Institute in its review of international evidence reported that schemes which allow early access in the USA and New Zealand tend to have more conservative investment approaches.[xliv]

Part 3:
Re-designing the Lifetime ISA

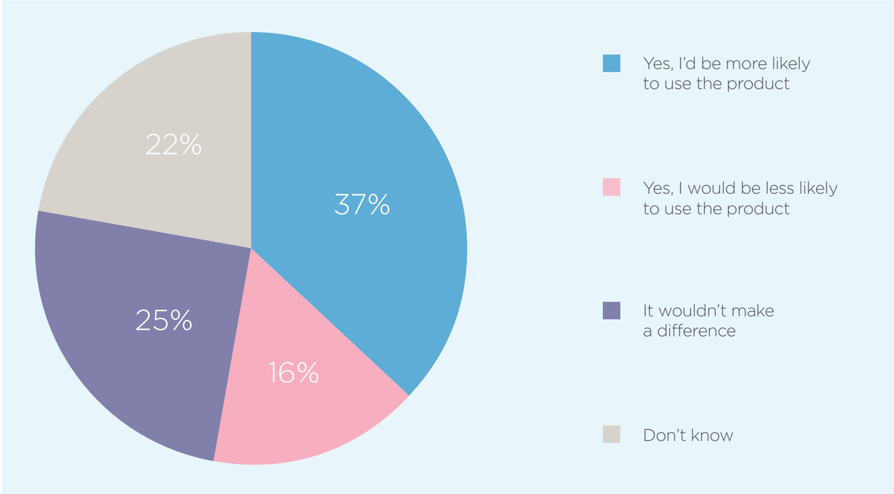
Part 2 illustrated some of the current design flaws in the LISA which would have to be overcome if the LISA were to become an efficient and attractive long-term savings vehicle. Currently we are encouraging young people to save into a product that could be sub-optimal for many. In particular there are problems if savers are to rely properly on the LISA as an alternative savings vehicle for retirement, such as retaining eligibility to benefits and access to employer contributions.

Below we describe how the product should be re-designed by government to achieve its potential.

Reform proposal: There should be an easy route for employers to contribute to LISA funds

The LISA is being marketed as a product that allows young people to save for retirement; it should therefore have the same status in relation to employer contributions as pension products. As it is, the loss of employer contributions will have a large impact on the value of savings at retirement, with those aged 18 to 21 on a median salary losing £316 per year. Within our research 37% of respondents stated that they would be more likely to use the LISA if employer contributions were included. This figure rises to 47% of those who are employed full-time.

Figure 13: Respondents' views on the appeal of the LISA if their employer could put money into their Lifetime ISA?



Source: SMF analysis of 3gem polling. Base: all respondents

Therefore, we **recommend** that the Government should ensure that those who save through a LISA are equally able to benefit from employer contributions as those who save through a pension.

Two specific aspects require further consideration:

1. **The tax treatment of employer contributions.** Employer contributions to a registered pension scheme are exempt from being taxed as earnings for the employee and can count as an expense of management.[xlv] A similar rule should be established for LISA contributions so that the decision to use a LISA or a pension product is based on the merits and the appropriateness of the product rather than any inherent tax incentive.

2. **The mechanics.** We envisage that individuals would provide the details of their LISA to their employer who would set up contributions as part of the payroll exercise, in a similar way that the employer pays into a pension scheme or contributes to other schemes such as childcare, bicycle loans or season tickets.

Reform proposal: Enabling LISAs to become auto-enrolment compliant

In addition to including employer contributions, there is potential to allow the LISA to be treated in the same manner as pensions within the auto- enrolment framework. Opt-out rates are thus far lower (c.10%) than they were predicted to be (c.20%). Moreover, opt-out rates among young people aged under 30 are low at 7%.[xlvi]

Currently, employers have to enrol their employees into an auto-enrolment compliant pension scheme. A beneficial reform would see employers permitted to meet their duties by defaulting eligible staff into a LISA of their choice or by contributing to an employee's personal LISA. This reform could provide greater choice to young people as they save as well as promoting greater competition in the savings market.

Within the current auto enrolment framework the majority of savers have very little say in which pension provider they save with. They rely on their employer as an agent to act in their best interests. This lack of buyer power has been stated as one of the barriers to increased competition within the pension market.[xlvii] Within this scenario, pension providers and LISA providers will find themselves competing for the business of employers and for savers who have their own LISA.

Particular aspects require further consideration:

- We may envisage employers offering both a LISA and a pension product to their workforce or opting for one or the other. For instance, employers will be able to decide whether to offer a traditional pension product and / or LISA based on the savings goals that they as employers would like to contribute to. However, current rules associated with LISA products may lead to unnecessary complications. For instance, while an employer can select a single pension scheme to service its entire workforce, this would not be possible with a LISA because individuals aged over 40 are not able to set up a LISA, whilst LISA-holders are not allowed to contribute to their LISA beyond the age of 50. Under these rules, it is likely therefore, that employers would have to run both a LISA and pension product scheme in parallel and switch employees from one to the other. These rules will therefore contribute to unnecessary complexity for individuals and businesses.

  It is unclear why those aged 40 and over are not permitted to open a LISA as the product already has clear restrictions on withdrawals; nor is it obvious why individuals can only save into a LISA up to age 50.

- The introduction of an additional product that is AE compliant may increase the administrative burden on employers if they choose to offer both in parallel. However, it should also provide greater choice to employees as well as potentially driving greater competitive pressure in the market.

- Regulators should ensure that there is a level playing field between pension products and LISAs, and relevant product regulations around charges should apply to all products available through AE. Pension products available through AE have their annual fees capped at 0.75% of the value of the assets. Given the fact that auto-enrolled savers are (by definition) inert, it will be important to ensure that protections such as through charge caps cover all product types.
- Consideration may also need to be given to default investment strategies. The DWP issued guidance on how AE providers should design their default investment strategies for savers who do not make an active decision on which fund to put their money in.[xlviii] Across all DC schemes, almost three quarters of individuals (73%) are put into the default fund that they are offered (although not all such individuals opt for the scheme due to disinterest, some believing it to be the best fund for them). The proportion who use the default funds are even higher among auto-enrolled savers. As of March 2014, 99% of savers in NEST were in the default fund.[xlix]

We **recommend** that the Government should permit LISA products to be used as compliant auto-enrolment savings products and that these products should adhere to the same rules on charges.

Reform proposal: Disregard LISA from means-tested benefits:

It was never previously intended that those who built up savings for their retirement should sacrifice the right to access benefits. However, we have explained above that those saving for retirement through a LISA could see their eligibility for means-tested benefits eroded. This could affect a significant portion of the population.

The Resolution Foundation has previously proposed that all savings put away into an ISA should be exempt from the means-test in Universal Credit.[l] In 2016, the think tank estimated that this would cost £200m per year. While we do not propose that all ISA holdings should be exempt, we do recommend that money held in LISAs should be because one of its two purposes is for retirement. Exempting LISA savings from the means-testing rules would come at a cost to the Exchequer because those who are using their LISA to build up money for a housing deposit would otherwise be caught in the means test.

We **recommend** that LISA savings should be exempted from the capital rules for means-tested benefits and support.

Reform proposal: Investment strategies and nudges:

As mentioned above consumers tend to prefer saving in cash, despite the benefits in the long-term that are typically associated with higher risk asset classes. This is in the wider context of recent OECD research which shows that the UK scores lower than the OECD average in terms of financial literacy.[li]

It is too early to say what providers will offer by way of investment options, how they will steer savers and how consumers will respond. There is currently one cash LISA on the market; this fund offers an interest rate of 0.5% AER.[lii] There are a number of stock and shares LISAs. We envisage that the market is likely to evolve to provide savers with a different range of products, including potentially default funds as occur in the pension market.

Depending how the market evolves, the Government may wish to intervene, though we would suggest that this is done initially in a light-touch way. In order to provide any guidance or steer, the provider must be aware of the savings purpose of the consumer – for instance some may be saving over the relatively short-term for a house purchase, whilst others may be saving over a 30-year period for their retirement.

Interventions could include:

- Requiring providers to explain the upsides and downsides associated with the saving in cash for the long-term. We note, for instance, that the current sole provider of Cash LISAs provides guidance around the limitations of saving in cash for retirement.
- Nudging consumers to switch investment strategy – for instance those consumers who withdraw money for a home purchase could be advised that saving for retirement requires a different investment strategy.

We **recommend** that the government should keep a watching brief of market developments in terms of investment strategies and consumer behaviours.

Reform proposal: Setting sensible withdrawal penalties

There is a trade-off between making a savings product attractive to savers versus ensuring that the policy objectives which result in it benefiting from tax advantages are achieved. As it stands, the LISA withdrawal penalty is much lower than the penalty for withdrawing money early from a pension pot (55%). Some have argued that the withdrawal penalty should be reduced or removed.[liii] However, there is an equally strong argument for increasing the penalty to dissuade savers from spending their retirement savings before older age.

We **recommend** that the government should keep the withdrawal penalty and assess over time whether it needs to be higher if many young people withdraw money.

Reform proposal: The age at which funds can be withdrawn from the LISA should be equalised with pensions and other age restrictions lifted

Under the current product design, savings being used for retirement purposes within the LISA cannot be withdrawn without facing a penalty until the individual is 60, this is five years later than the current pension withdrawal age. In fact, the disparity is likely to be narrower in actuality because the state pension age and the age at individuals are allowed to access their pensions will rise over time. Those young enough to be eligible to save into an ISA will see a state pension age of 68 and a pension access age of 58.

However, there appears to be no logical reasoning why retirement savings should not be accessible at the same age whether they are accumulated through a pension product or a LISA. Either the age for pension products should be increased to 60 or the age for LISA withdrawals reduced to 55. It would probably be simplest to align it to the pension access age as this is automatically linked to the state pension age.

We **recommend** that the age at which LISA savers can access their money for retirement purposes should be equalised with the rules for accessing a pension, namely be brought forward from 60 to 55.

As noted earlier, the current restrictions on when someone can open an ISA (maximum age 39) and when someone can contribute to their LISA (maximum age 50) are likely to make the savings market unnecessarily complex. Given there are already strict rules on what a LISA is for and on withdrawals, the entry restriction seems unnecessary.

The age restriction on contributions is more complicated but should also be reformed. In the last Autumn Statement, the Government announced reforms to be introduced in spring 2017 which reduced the 'Money Purchase Annual Allowance' from £10,000 to £4,000. The Government acted in this way to 'limit the extent to which pension savings can be recycled to take advantage of tax relief'. The MPAA exists to counter the risk that an individual diverts their salary into their pension scheme, gaining tax relief, and then effectively withdrawing 25% tax-free. The policy also restricts the extent to which individuals can 'gain a second round of tax relief by withdrawing savings and reinvesting them into their pension'. A similar dilemma is relevant to the LISA, namely that: an individual may withdraw savings from their LISA at age (say) 60 and then put this money back into the LISA and thus gain an additional bonus of 25%. In such an instance, the individual will have received the bonus twice. Therefore, the Government may need to consider lowering (or removing) the maximum annual bonus that a saver can receive for those individuals who have made a retirement withdrawal if it perceives the risk of this tax arbitrage to be significant.

We **recommend** that the age restriction on when individuals can start saving into an ISA should be lifted. At the same time, the Government should lift the age restriction on when savers can continue to contribute to a LISA and approach it in the same way as pension products.

Tax relief

In researching this policy area, we note that higher-rate taxpayers would still be better-off saving through a pension product rather than a LISA even under the reforms we describe above. However, there are a number of reasons why we do not propose an alternative incentives regime. First, having a single bonus provides simplicity to the scheme and this is likely to attract more people into LISAs than if it were to mimic the complex structure of incentives in pension products. Second, there is a much wider debate that is needed about savings incentives, including whether it is desirable for such a large proportion of pension tax relief to be taken by higher-rate taxpayers. The Government consulted on this in 2015 and may reform the system in due course.[liv]

Part 4:
Prospects under a re-designed LISA

Part 3 described a series of potential reforms to the LISA with the purpose of increasing savings levels and injecting greater choice and competition into the market.

Table 4 below provides a snapshot of outcomes for savers under the current LISA, our re-designed LISA and a pension product. As can be seen in most cases, the LISA now no-longer contains the flaws that make it a worse product than a pension product.

Table 4: Outcomes under different saving products

	Pension product	Current LISA	Re-designed LISA
Employer contributions	Y	N	Y
Flexibility to buy a first home	N	Y	Y
Savings excluded from benefit means-tests	Y	N	Y
Early withdrawal penalty	55%	25%	25%
Age of access	55	60	55
Zero-rate taxpayer		Better off compared to pension	Better off compared to pension
Basic rate taxpayer		Better off compared to pension	Better off compared to pension
Higher rate taxpayer		Worse off compared to pension	Worse off compared to pension

Footnotes

i It will replace the Help to Buy ISA from 2019.

ii https://www.gov.uk/lifetime-isa. There is also a provision that the penalty does not apply if the individual is terminally ill or has less than 12 months to live.

iii https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508176/Lifetime_ISA_final.pdf

iv HM Treasury, Impact Assessment: Savings (Government Contributions) Bill (October 2016)

v HM Treasury, Impact Assessment: Savings (Government Contributions) Bill (October 2016); OBR, Economic and fiscal outlook (March 2016)

vi Work and Pensions select Committee, Automatic enrolment (2016)

vii http://www.thepensionsregulator.gov.uk/press/pn17-15.aspx

viii The Pension Regulator, Declaration of compliance report (2017)

ix DWP, Workplace pensions: Update of analysis on Automatic Enrolment 2016 (2016)

x HM Treasury, Impact Assessment: Savings (Government Contributions) Bill (October 2016)

xi Katie Evans and Emran Mian, Savings in the balance: managing risk in a post-crisis world, (SMF, 2014)

xii https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/nrjs

xiii HM Treasury, Impact Assessment: Savings (Government Contributions) Bill (October 2016)

xiv https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/560356/workplace-pensions-update-analysis-auto-enrolment-2016.pdf

xv DWP, Workplace pensions: Update of analysis on Automatic Enrolment 2016 (2016)

xvi Katie Evans and Emran Mian, Savings in the balance: managing risk in a post-crisis world, (SMF, 2014)

xvii Pensions Policy Institute, Tax relief for pension saving in the UK (2013)

xviii Nigel Keohane and Nicole Gicheva, Millennials and Finance (Tesco Bank, 2017)

xix Katie Evans and Nigel Keohane, Locked Out: How property crowdfunding could help the next generation of homeowners (SMF, 2016)

xx https://www.ons.gov.uk/peoplepopulationandcommunity/housing/bulletins/housingaffordabilityinenglandandwales/1997to2016

xxi ONS, Occupational Pension Schemes Survey, UK: 2015 (2016)

xxii Bank of England, Financial Stability Report, Issue No. 41, (2017)

xxiii For instance, 57% of those who own a home with a mortgage reported that saving for a home was not a priority.

xxiv OFT, Defined contribution workplace pension market study, (2013)

xxv DWP, Public consultation: Better workplace pensions: a consultation on charging (2013)

xxvi Department for Work & Pensions, The charge cap: guidance for trustees and managers of occupational schemes, (2016)

xxvii FCA, Competition Report, 2013-16 (2016)

xxviii https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf

xxix FCA, Handbook changes to reflect the introduction of the Lifetime ISA: Feedback on CP16/32 and final rules, PS17/4 (2017)

xxx FCA, Handbook changes to reflect the introduction of the Lifetime ISA: Feedback on CP16/32 and final rules, PS17/4 (2017)

xxxi https://www.gov.uk/workplace-pensions/what-you-your-employer-and-the-government-pay

xxxii Michael Johnson, The Life ISA: Potential Next Steps (CPS, 2016)

xxxiii https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417473/pension-flexibilities-dwp-benefits.pdf

xxxiv FCA, Handbook changes to reflect the introduction of the Lifetime ISA: Feedback on CP16/32 and final rules, PS17/4 (2017)

xxxv Djuna Thurley, Lifetime ISA and pensions (House of Commons Library Note, 2016)

xxxvi Michael Johnson, A Pensions and Savings Manifesto, (Centre for Policy Studies), (2017)

xxxvii FCA, Handbook changes to reflect the introduction of the Lifetime ISA CP16/32 (November 2016);

xxxviii https://www.fca.org.uk/consumers/early-pension-release

xxxix Michael Johnson, The Life ISA: Potential Next Steps (CPS, 2016)

xl http://www.schroders.com/en/uk/private-investor/insights/markets/cash-v-shares/

xli FCA, Handbook changes to reflect the introduction of the Lifetime ISA CP16/32 (November 2016);

xlii https://www.moneyadviceservice.org.uk/en/articles/should-i-save-or-invest

xliii Katie Evans and Emran Mian, Savings in the balance: managing risk in a post-crisis world, (SMF, 2014)

xliv PPI, Lifetime ISAs—the international evidence (2016)

xlv https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim46010

xlvi PPI, The impact of automatic enrolment in the UK as at 2016 (2017)

xlvii OFT, Defined contribution workplace pension market study, (2013)

xlviii DWP, Guidance for offering a default option for defined contribution automatic enrolment pension schemes (2011)

xlix Nigel Keohane and Simon Rowell, Good Pensions (SMF, 2015)

l Resolution Foundation, Making the most of UC: Final report of the Resolution Foundation review of Universal Credit (2015)

li OECD, International survey of adult financial literacy competencies, (2016)

lii http://www.money.co.uk/savings-accounts/lifetime-isas.htm

liii See responses to the Government consultation on the Lifetime ISA.

liv Pensions Policy Institute, Tax relief for pension saving in the UK, (2013)