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Lifetime ISAs: pension complement or rival?

Introduction

In July 2015 HM Treasury launched the consultation "Strengthening the incentive to save: consultation on pensions tax relief".[1] Responses considered both the current system and potential alternatives; generally variations of the current EET system or a TEE system (see Table 1).

No new changes were announced in the March 2016 Budget. However, the Budget did introduce the Lifetime ISA (LISA) as "a completely new flexible way for the next generation to save".[2] The LISA provides a complementary savings option to the current pensions system for retirement saving and to the current help to buy ISA for saving towards a first house purchase.

The LISA is in addition to the personal savings allowance, introduced in the March 2015 Budget. The impact of the new allowance is that most people will no longer pay tax on savings interest, with £1,000 of savings interest income tax free for basic rate tax payers (and £500 for higher rate tax payers). This results in a TEE savings structure, similar to an ISA, for most people.

This Briefing Note details the structure of a LISA, compares this with the savings alternatives for house buying and retirement. The LISA is then considered from the viewpoint of the individual saver and potential savings outcomes are modelled under various circumstances. The role of third parties such as employers and trustees are considered before concluding with identifying some outstanding questions and conclusions drawn from the introduction of LISAs.

Table 1: EET and TEE systems
The current pensions system is described as EET (despite not adhering exactly), whereas an ISA is described as TEE

EET	TEE
Exempt Contributions are exempt from tax	**Taxed** Contributions are made from taxed income
Exempt Investment growth of funds are exempt from tax	**Exempt** Investment growth of funds are exempt from tax
Taxed Withdrawal from a fund is taxed as income	**Exempt** Withdrawal from a fund is not subject to tax

The structure of a LISA

The LISA is a TEE savings vehicle designed to be used for saving for either a house purchase, retirement or both. It offers an ISA style of saving with both incentives and penalties designed to influence the saver's behaviour.

1) Eligibility
- Anyone from age 18 until their 40th birthday is eligible to open a LISA.
- At launch, this excludes all those born before 7th April 1977.

2) Contributions
- Contributions are to be made from taxed income.
- The Government will pay a matching bonus of 25% of the saver's contribution.
- The bonus is capped at £1,000 each year.
- The bonus is only available on contributions made before the age of 50.

3) Investment returns
- Investment returns are not subject to taxation.

4) Withdrawals
- Withdrawals may be made from the age of 60, or where the funds are used for the purchase of a first house.
- Any other withdrawals will be subject to a 5% exit charge as well as forfeiting the Government bonus and any investment return upon it.

Table 2: Comparison of the alternative savings options

The table below highlights default behaviour and options. The pension scheme is based upon the minimum an employer must offer, 2016-17 thresholds, a net pay arrangement and the long term contribution rates from the stage at which an individual would be defaulted in to the pension scheme.

Criteria		Help to buy ISA	LISA (some details to be confirmed)	Automatic enrolment workplace pension scheme
Opening the savings	Age	Aged 16+	Aged 18-39	Aged 22—SPA
	Other	Before December 2019	From April 2017	Earning £10,000 per year
Contributions	Saver	Up to £1,000 initial deposit Up to £200 per month	Up to £4,000 per year	4% of salary above £5,824 to a maximum value of £1,487.20
	Employer	Zero	Zero	3% of salary above £5,824 to a maximum value of £1,115.40
	Government	Zero	Bonus of 25% of contributions paid at the end of the tax year.	Pensions tax relief on savers contributions: Basic rate: 25% Higher rate: 66%
Investment and returns	Strategy	Cash investment	Cash or stocks and shares investment. Strategy selected by the investor	Long-term mixed investment strategy Default strategy selected by scheme trustees
	Tax status	Exempt from tax	Exempt from tax	Exempt from tax
Withdrawal	Restrictions	For first house by 2030 otherwise the withdrawal bonus is forfeited.	For a first house **or** from age 60 . Otherwise a 5% exit fee and the bonus is also forfeited.	From age 55. Otherwise taxation at 55%.
	Bonuses	25% of balance up to £3,000	Zero	Zero
	Tax status	Exempt from tax	Exempt from tax	25% available as tax free lump sum. Remainder liable for income tax.
Anything else		Liable for inheritance tax. Accounted for in benefit entitlement calculations.	Liable for inheritance tax. Accounted for in benefit entitlement calculations.	Can only be accessed early for critical illness or death.

Alternatives to a LISA

As the LISA supersedes the Help To Buy ISA (available from Autumn 2015) for house buying, and can also be used as a retirement savings vehicle, comparisons between the three options are covered in Table 2.

The individual saver

An individual taking out a LISA may have the intention of either saving towards a first house purchase, their retirement, or both.

Using the LISA for anything else apart from a first house or at 60

The penalties for withdrawal from a LISA for any other reason make this vehicle unattractive. However, it is conceivable that a saver may wish access to their funds as a result of other financial pressures.

Chart 1 illustrates the period that the penalties apply.

With this issue in mind, the Government has announced that it will consult upon allowing borrowing from the fund without loss of the bonus. This would introduce similarities with the US 401(k) plans.

The saver will need to consider an appropriate investment strategy, fit for the savings ambition, and how the LISA may fit alongside other saving options.

Investment strategy

For all savings the investment strategy adopted will be an important factor in determining the outcome.

Saving towards a house and a pension do not typically share a common saving strategy. For an individual opening a LISA at age 18, retirement is three times further away than the average age of a first time buyer in the UK, currently 31.[3]

A cash based investment strategy does not generally yield the optimal outcomes for long-term savings and is more suited to short-term savings ambitions.

However the investment strategy employed may be influenced by the branding as an ISA. Currently just under 80% of all ISA accounts are cash ones (100% of Help To Buy ISAs), and over 75% of savings contributions made into an ISA in 2014-15 were invested in cash.[4]

Long-term savings levels and the bonus cap

It is possible that a LISA could be used instead of, rather than as well as, existing forms of long term savings, as the contribution rates are consistent with those of, for example, personal pensions.

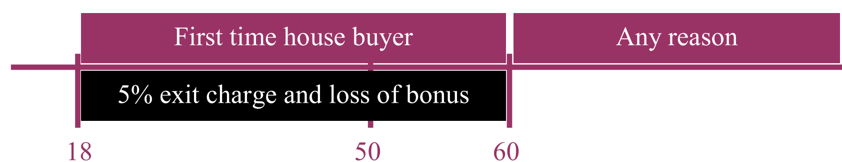
A saving level of £4,000 pa implies a savings rate of approximately 20% after tax on the UK median annual salary of £22,000.[5] At the threshold income for higher rate tax (£43,000 for 2016-17) £4,000 equates to a contribution rate of over 10% after tax.

Compared to the current long-term savings rates of employees under 50, over 90% contribute less than 7% of their income into Defined Contribution pension schemes.[6] Therefore, to the large majority of the long-term saving population the £4,000 limit for contribution matching will not have an impact at current saving rates. It is more probable that short-term savers looking to fund a house purchase might be affected by this cap.

Chart 1: A LISA timeline

Contributions can be made from age 18, with a bonus earned between ages 18 and 50.

Money can be withdrawn without penalty from age 60 or for the purchase of a first house at any time.



Potential savings outcomes

PPI modelling[7] looks to support an income after retirement. The modelling calculates for how long this income in retirement can be supported by the savings from each scenario.

For an individual currently aged 25 and earning £18,000 the following saving scenarios are considered:

- Workplace pension: An automatic enrolment workplace pension scheme (as Table 2).
- LISA (pension strategy): Saving the same amount of money (as contributed by an employee under automatic enrolment) in a LISA, with an investment strategy matching the workplace pension.
- LISA (cash strategy): A LISA invested in cash.
- LISA (house buyer): A LISA, where funds are withdrawn for a house purchase before continuing saving for retirement with the same cash investment strategy.

The post-retirement income from the new State Pension and the funds accumulated in a LISA is modelled as equivalent to £15,000 pa, before tax. A figure identified by NEST as likely to be a good indicator of comfort and financial stability in retirement.[8]

From the different scenarios, the funds in the LISA will potentially last up to:

- **4 years** when used to fund a house purchase (house buyer).
- **5 years** when invested in cash (cash strategy).
- **11 years** when adopting a long term savings strategy (pension strategy).

Chart 2: A LISA may offer a similar longevity of post-retirement income to the current system

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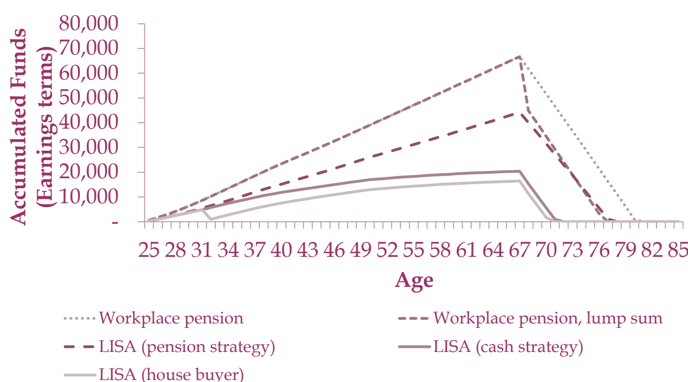
Fund build-up and decumulation considering potential behaviour when saving in a LISA.



After this period the income of the individual may be reduced to the new State Pension, unless they have other wealth that can be converted to income (Chart 2).

These figures compares to **14 years** of income that could be taken from the pot accrued under a workplace pension (workplace pension). However it is likely that 25% of this pot will be taken as a tax free lump sum. When 25% of the pot is taken as a lump sum the remainder of the fund is projected to last up to **10 years**, (workplace pension, lump sum).

As the whole LISA fund is exempt from income tax, it is hard to assess the proportion of the fund that may be used for retirement income. Individuals may spend the entire fund on future income, or may withdraw it all at once.

Using a LISA and pension as a hybrid approach

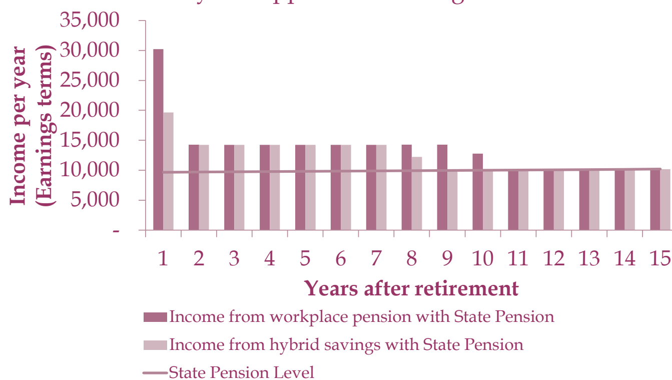
A hybrid approach to saving in a LISA / pension could involve the following stages during an individuals lifetime, assuming a house purchase at age 31 as before:

- **Age 25—31** cash investment strategy in a LISA to fund house purchase.
- **Age 32—49** long term investment strategy in a LISA taking advantage of the bonus on contributions.
- **Age 50—67** investment in workplace pension scheme taking advantage of employer contributions.

Employer contributions on pension savings are lost until age 50. But a greater degree of fi-

Chart 3: Workplace pension savings may last two years longer than a hybrid savings approach

Post-retirement income from savings accumulated in a workplace pension scheme may last longer and provide a greater lump sum upon retirement than a hybrid approach to savings.



nancial support via the bonus comes from the Government when compared to the employer contributions to a workplace pension.

Comparing the post-retirement income from this hybrid savings approach to that from a straightforward workplace pension with the same contributions from the saver, the workplace pension can provide both a larger lump sum and a longer lasting retirement income before the funds are exhausted and income is taken from the State Pension only. This is due to the employer contributions throughout the savings period and despite the more advantageous tax position of the savings in a LISA (Chart 3).

These figures assumes that 25% of the pension pot is taken as a lump sum in both scenarios (only from the workplace element in the hybrid scenario) and the remainder is used to provide an income in retirement. This results in a lump sum of £16,000, in current earnings terms, being available for the workplace pension scheme, three times larger than the lump sum available in the hybrid approach.

Under the hybrid approach (not illustrated in Chart 3) the withdrawn fund for the house purchase is worth just under £5,000 (including approximately £1,000 of Government bonus) in current earnings terms. Any additional saving towards a house purchase funnelled through a LISA would result in an additional bonus on that saving.

This approach could result in greater housing wealth at retirement and potentially create additional post-retirement income through equity release. However investment in housing may not represent the most effective method of saving for retirement. The Office for Budget Responsibility forecasts house price inflation to be below the return that could be expected upon the assets of a pension fund in the long run.

Additional retirement saving

The effect of potentially missing out on employer contributions outweighs the impact of tax treatment in the choice between the savings systems if a LISA is used as a replacement for a workplace pension. However where there is no loss of employer contributions (such as for the self-employed or those who save on top of their workplace pension scheme) the outcome is influenced more by the tax treatment.

Table 3 shows the potential fund accumulated by investing £1,000 thirty years before retirement and saving into one of the following systems:

- **Pension saving** which assumes a long-term investment strategy and the outcome depends upon the tax status of the saver.
- **LISA** which depends upon the investment choices of the saver.

A higher rate tax payer stands to achieve a 13% better outcome in the pensions system than investing in a LISA, however a basic rate tax payer could be 15% worse off assuming they invest in a similar way to the pension.

Table 3: The value of a £1,000 investment
The outcome under a LISA is not dependent upon the tax status of the saver. It is assumed that income tax is payable in retirement at the basic rate.

Values are nominal		Pensions system		LISA	
		Basic rate tax payer	Higher rate tax payer	Pensions strategy	Cash strategy
Contributions	Saver	£1,000	£1,000	£1,000	£1,000
	Tax relief	£250	£667	£0	£0
	Bonus	£0	£0	£250	£250
	Total	£1,250	£1,667	£1,250	£1,250
Accumulated value of saving at retirement with investment returns		£7,179	£9,572	£7,179	£2,264
Funds available after tax liability on withdrawal		**£6,102**	**£8,137**	**£7,179**	**£2,264**
Compared to pensions invested LISA	**Nominal**	-£1,077	£957	-	-£4,915
	Percentage	-15%	+13%	-	-68%

Where an individual saves into a LISA using a cash based investment strategy they could be 68% worse off than with a pensions style investment strategy.

The greatest component to the final outcome is the investment return, and not the tax treatment of the savings.

It is however clear that the LISA does contain potential benefits for some savers if used to complement current savings options within the pensions system.

Paying income tax in retirement

For those with less substantial savings and an approach to decumulation aiming to last their lifetime, they may not be liable to pay income tax in retirement. After allowing for the new State Pension there remains nearly £3,000 of personal income allowance available to an individual.

Assuming a 25% tax free lump sum and income drawdown at a rate of 5% per year a pension pot at retirement of up to £77,000 will attract no income tax. For many individuals, the current pensions system could therefore already be entirely tax exempt if they manage their decumulation suitably, (though this could lead to a lower standard of living).

The role of the employer

Anyone opting out of a workplace pension to invest elsewhere stands to miss out on the substantial proportion the employer contribution makes up of the final fund. The employer contributions to a workplace pension, which under automatic enrolment could make up 37.5% of the value of the final pot, would not be available for investment in a LISA.

From an employer's perspective an individual who opts out of a workplace pension scheme to invest in a LISA represents a saving and potential conflict to the promotion of automatic enrolment workplace pensions, as employer pensions contributions will not need to be paid.

The role of trustees and governance

The role of trustees and Independent Governance Committees[9] (IGC) is to consider the best interests of the members of

their scheme(s). This results in many of the features, including default options, of a particular pension scheme being defined by such bodies. They also consider aspects such as charges, communication and administration. Such governance has an emphasis upon securing better outcomes for the saver.

Included in the governance is the selection of investment options, specifically the default fund which is put in place to best serve the membership as a whole. Individuals within the membership may be relatively advantaged or disadvantaged by this choice, however they are free to move away from the default approach and into any other investment options offered by the pension scheme.

LISAs will exist in a market place driven by the consumer, where the saver is expected to identify and execute an appropriate investment strategy, understand the charges being applied and assess the relative value for money of the varying offerings.

There is no default option which has been selected to represent the best interests of the members and they may be forced to seek financial advice at their own expense where the cost may make this an unattractive option. "It may be less cost-effective for individuals with small pot sizes to obtain advice."[10]

Conclusions

There are still aspects of the LISA which are uncertain including:

- Who will invest in LISAs?
- Will LISAs result in new savers and / or higher levels of saving from existing savers?
- Will the outcome of LISA saving be optimal for the saving purpose?

There is a potential redirection of saving to a LISA from other savings vehicles including workplace pensions and the current Help To Buy ISAs. This behaviour may be influenced by a number of factors:

- Using the bonus to offset income tax on the contributions.
- The attraction of the ISA brand which is widely recognised.
- Misunderstanding and lack of knowledge of the current pensions system.
- Distrust that the Government may alter legislation affecting pensions savings in the future.

In some cases this could lead to a poorer outcome for the individual, through either reduced investment returns, missed employer pensions contributions, or through penalties as a result of early withdrawal of funds.

When saving towards a house LISAs could represent an attractive and potentially valuable form of saving. They are likely to be popular due to the ISA brand.

But the impact upon retirement saving is ambiguous and depends upon:

- Whether it would replace or complement existing pensions savings and in particular whether employer pension contributions will be missed.
- Whether saving persists in LISAs beyond house purchase.
- How the saving is invested, whether in cash or pension-like investments.
- How much a LISA costs and how well governed investments are.

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1 HM Treasury (2015-16): Strengthening the incentive to save: consultation on pensions tax relief
2 HM Treasury (2016): Budget 2016
3 ONS (2016): House Price Index: Annual table 37
4 HM Revenue & Customs (2015): Individual Savings Accounts statistics
5 ONS (2015) Annual Survey of Hours and Earnings: 2015 Provisional Results
6 ONS (2016) Employee Contribution Bands by Age Group and by Pension Type (P5)
7 PPI Individual model using current assumptions
8 NEST (2014): Retirement Realities: Tomorrow's worth saving for
9 PPI (2016) : Independent Governance Committees (IGCs), Briefing Note Number 80
10 FCA (2016) : Financial Advice Market Review, Final report

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