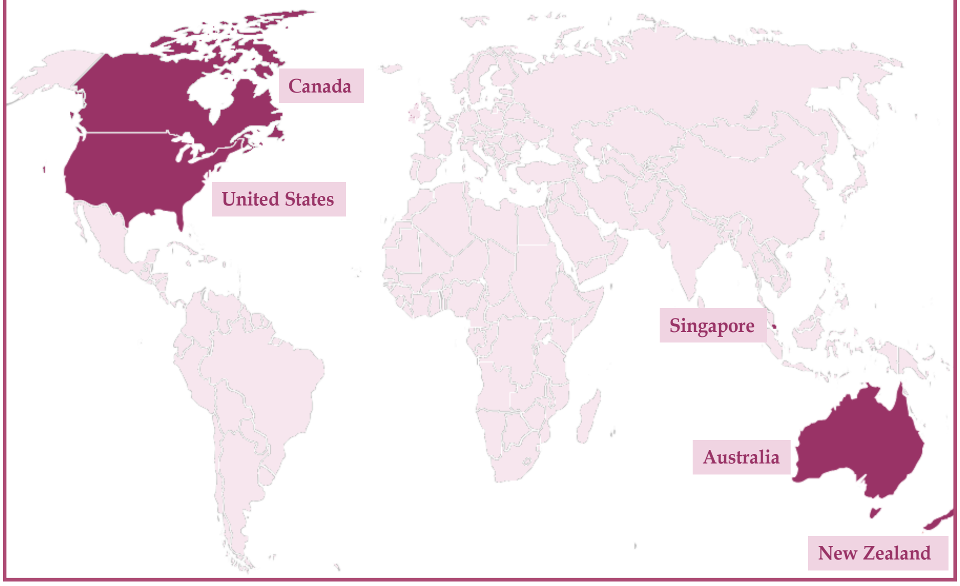
Lifetime ISAs—the international evidence

Introduction

The Lifetime ISA (LISA), was announced in the March 2016 Budget, and will be introduced in April 2017. The LISA can be used to save for a house purchase, for retirement, or both.

The LISA is open to anyone under the age of 40. Savers will be eligible to receive 25% matching payments from the state of 25% of contributions, up to the value of £1,000 per year (i.e. £4,000 in saver contributions = £1,000 in govt. matching). People will cease to be eligible for matching contributions once they reach the age of 50.

Chart 1: This note uses evidence from the pension systems of Australia, New Zealand, the United States, Canada and Singapore to draw conclusions about the potential impact of introducing LISAs



LISA savers are permitted to withdraw funds, tax-free, to purchase a first house up to the value of £450,000. Withdrawals are also tax-free after the age of 60. Withdrawals made before age 60 and not used for a house purchase incur a 5% tax charge, and any Government contribution is lost.

In private pensions, contributions and returns receive tax relief while withdrawals made after the age of 55 are taxed at marginal rates (with 25% of the pension fund tax-free). In this way, UK pensions are Exempt, Exempt, Taxed-"EET".

Contributions to non-pension, tax-advantaged savings vehicles, ISAs, are taxed, while relief is given to returns and withdrawals. ISAs are therefore Taxed, Exempt, Exempt-"TEE".

The introduction of the LISA represents a diversion from this tax regime as the LISA is described as a retirement savings vehicle but is TEE, though as the matching contributions from Government provide the equivalent of basic rate tax relief on contributions of up to £4,000 yearly, until the age of 50, the T could be considered a small "t".

For a more detailed explanation of how the LISA works and how it compares with saving in a private pension, please see PPI Briefing Note 81 Lifetime ISAs: pension complement or rival?

This Briefing Note was commissioned by Royal London to explore the interaction between the LISA and other elements of the pension system with reference to evidence from Australia, New Zealand, United States, Canada and Singapore (Chart 1).

The next section summarises the key implications arising from international evidence for the UK.

Summary of main implications for the UK

- Other countries which allow early access to retirement savings typically have mitigating features. There is less inherent protection within the LISA than for those who use international pension schemes for early access.
- Individuals in some other countries can borrow or make early withdrawals directly from their pension pots for a house purchase. Take up is low at around 2% in Canada and New Zealand. In contrast, in the UK, people are

required to set up a new savings vehicle alongside or instead of their pension if they wish to use the LISA to save for a home. This means that people wishing to combine pension saving and saving for a home might forgo employer contributions, which can reduce the funds available at retirement by up to a third.

- In Canada and the US, people must repay early withdrawals in order to avoid tax penalties. The lack of a repayment facility will result in a greater reduction in pot size for LISA savers than for those required to repay.
- There is evidence that schemes which allow early access in the US tend to have more conservative investment approaches than those which don't. KiwiSavers (NZ) also seem to favour relatively conservative investment approaches.

If this association also translates into more conservative investment behaviour for LISA savers in the UK, then they may accrue smaller pots than people making the same contributions would do in a private UK pension scheme.

- Some pension schemes in other countries which allow early access also use tax to incentivise phased withdrawals in retirement. While UK private pension schemes also have these incentives, LISAs will not, being TEE. As a result, those saving for retirement in a LISA may withdraw larger lump sums during retirement and run out of funds earlier than they would have if they had saved in a private pension.
- LISA providers might need to monitor eligibility and compliance with early withdrawal regulations. The added administrative burden could result in extra charges for LISA savers.
- Other countries combine early access with private pension schemes, meaning savers are protected by pension regulation. LISA savers will not be protected by pension specific legislation in the UK and may not benefit from protections such as the charge cap. Higher charges can erode the value of a pot over time by around 13% (0.3% vs. 1%-1.5% charges).
- Unlike in other countries, LISA savers won't have easy access to the same income conversion options as people saving in private workplace pensions because the income from these products is taxed on withdrawal. LISA savers are unlikely to use traditional drawdown or annuity products, which are designed to help people manage funds in retirement and make withdrawals in a phased way.
- Tax exemptions in TEE are not guaranteed. In systems where the Government feels people are taking too much tax-free income in retirement, they may apply retrospective taxes or caps on the amount of income which can be withdrawn tax-free; as seen in the Australian experience.

Chart 2: Features in countries which allow early access to private pensions

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	Overview of pension system	Early access features	Other points of relevance
Australia	Minimum age of access is 55 rising to 60 Contributions are taxed, returns and withdrawals are tax-free	Early access for - health problems, financial hardship, changing employer after age 60	The 2016 Budget included a proposal to place a retrospective cap of AS$1.6m on pension withdrawals
New Zealand	Minimum age of access is 65. Contributions and returns are taxed, withdrawals are tax free	Early access for - health problems, purchase of first home, financial hardship and emigration.	NZ has a relatively generous state pension - when house purchase reduces pot size, people may still have adequate retirement savings
USA	Minimum age of access is 59.5. Contributions and returns for 401(k)s and IRAs are given tax relief. Roth 401(k)s and IRAs are taxed at source with relief given to returns and withdrawals.	People may borrow up to half of funds in 401(k) plan, up to £50,000.	Roth-IRAs invested more in equities than traditional IRAs[3] possibly as there are no minimum withdrawal requirements.

The next section of this Note summarises early access arrangements in the other countries. Chart 2 sets out relevant elements of the Australian, New Zealand and US pension systems.

Australia: Superannuation

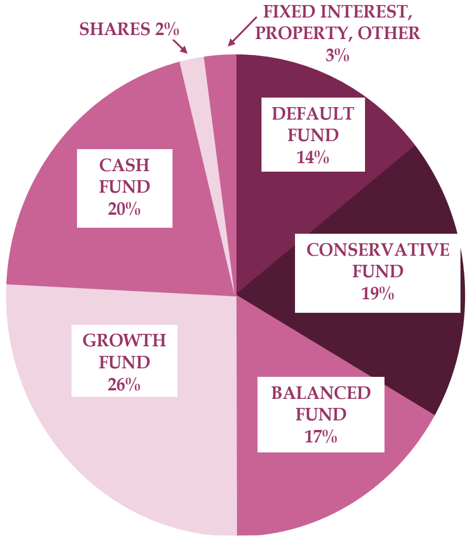
- **Early access:** Early access is allowed for health problems, financial hardship, those leaving employment after the age of 60 and those permanently departing from Australia.
- The Government determines eligibility and Superannuation funds administer early access grants.
- **Taxation:** Australian private pension contributions are broadly TEE. However, the Australian 2016 Budget included a proposal to place a retrospective cap of AS$1.6 million on the withdrawal of pension funds in retirement, with the excess being taxed at 15%. This change is part of an overall campaign towards higher tax efficiency and increasing the Government's revenue.
- **Investment strategy:** Most Australian private pension funds do not vary their default asset allocation in the lead up to retirement.[1] This is due to change by July 2017 when all remaining default fund balances must be transferred to MySuper products, which must offer a single diversified investment strategy or a lifecycle investment strategy.

New Zealand: KiwiSaver

- **Early access:** In New Zealand it is possible to withdraw savings from KiwiSaver (the automatic enrolment scheme) for a first-home purchase provided that NZ$1,000 remains in the account and the individual has been a member for at least 3 years. People can withdraw a maximum of $20,000, depending on type of home purchased and length of scheme membership.
- Housing New Zealand, (a Crown agent which provides housing to vulnerable people) is responsible for determining eligibility and administering the grants.
- **Taxation:** Contributions to private pensions are TTE.
- **Take-up of early access:** In 2015, 46,149, 1.8%, out of around 2.5 million members have taken the first home withdrawal.[2]
- **Investment strategy:** The asset allocation of KiwiSaver funds is relatively conservative, particularly when considered in light of the fact that two-thirds of members are aged under 45.[3] 14% of KiwiSaver members are in the conservative default funds, while 43% of the remainder have selected conservative, cash or fixed interest funds (Chart 3).[4] NZ's early access system may have led to more conservative investment approaches in order to limit volatility and maintain funding levels for early withdrawals.
- It is possible that pension savers intending to purchase a house with LISA savings might be more likely to favour a conservative investment approach.
- **Adequacy:** The impact of early access on adequacy of retirement income is of less concern in New Zealand than in the UK, as the residency-based state pension is 40% of

Chart 3: Kiwisavers tend to favour relatively low-risk funds

Membership of Kiwisaver funds



average worker earnings. In contrast, the UK new State Pension of £155.65 is around 24% average worker earnings.[5] Therefore, any considerations of the New Zealand early access system should take into account the relatively generous state pension.

United States: 401(k)s and IRAs

In the US 401(k) plans are workplace pensions and Individual Retirement Accounts (IRAs) are individual pensions. 401(k)s and IRAs are broadly EET, with tax-relieved contributions tax applied to withdrawals. *Roth* IRAs and 401(k)s, on the other hand are also available. Roth schemes are similar to the traditional schemes except that they are TEE. In 2014, 19.2 million households had a Roth IRA and 31.3 million had a traditional IRA.[6]

Increasing numbers of employees are opting for Roth 401(k)s, with the proportion of eligible employees saving in Roth 401(k)s increasing from 8% in 2011 to 11% in 2014. Those opting for Roth 401(k)s tend to be younger, wealthier and male. 17% of 401(k) participants age 20-29 are using Roth, compared to 13% of those aged 30-39, and between 6% and 10% of those in older age groups. The Roth option appeals particularly to those in younger age groups who will have many years of investment returns to build up and take in retirement. Younger workers also benefit more from Roth, as they generally have lower tax rates than older workers. The Roth option is more appealing to those who expect to have higher future tax rates and those who wish to leave tax-free income to a dependent which they can continue investing.

Only around half of employers offer contributions to a Roth 401(k) because contributions are post-tax and therefore more expensive for employers. Therefore not all employees have access to a Roth 401(k).[7]

- **Early access:** Plan sponsors (employers) can decide the extent to which early access is allowed. Some schemes allow loans in cases of financial hardship. Other plans allow people to borrow money for purchasing a house, home improvements or other specific purposes. Individuals are able to borrow from their EET 401(k)s up to the lower of $50,000 or half their fund value, but they must pay the loan back within five years in order to avoid paying income tax on the withdrawal amount plus a 10% early withdrawal penalty. Plan sponsors are responsible for reporting the tax position of 401(k) members to the Government.
- There is no borrowing allowed from IRAs.
- It is the employer sponsor of 401(k) plans who is responsible for assessing eligibility for and ensuring repayment of loans, though this is often carried out in practice by third-party scheme administrators.
- Around 40% of people take loans from their 401(k)s. Those borrowing from 401(k)s are generally younger; 17% of millennials (b. 1980-2000), 13% of generation X (b. 1965-1979), and 10% of baby boomers (b. 1946-1964) reported having taken loans from their plans (2014). Those taking loans are also more likely to be on low-incomes and be in financial difficulty.[8]
- Around 10% of people taking loans miss at least one repayment, and some of these people default altogether. In total, around $6bn is paid out each year by 401(k) members through extra tax and penalty payments for defaulted loans.[9]
- **Investment strategy:** TEE Roth accounts, which do not allow borrowing, tend to have higher allocations to equities than traditional EET accounts which do allow borrowing. However, this may be related to tax rules which require minimum distributions in retirement from EET pension funds, but not from TEE pension funds.[10]
- **Take-up:** Around a quarter of members use the borrowing facility, with around 26% of eligible participants having loans outstanding.[11]

Canada: Registered Retirement Savings Plan

- **Early Access:** Canadians are able to borrow up to C$25,000 from their Group Registered Retirement Savings Plan in order to purchase a house but must pay this back within 15 years, starting payments in the second year after the withdrawal. This scheme is not limited to the first home.

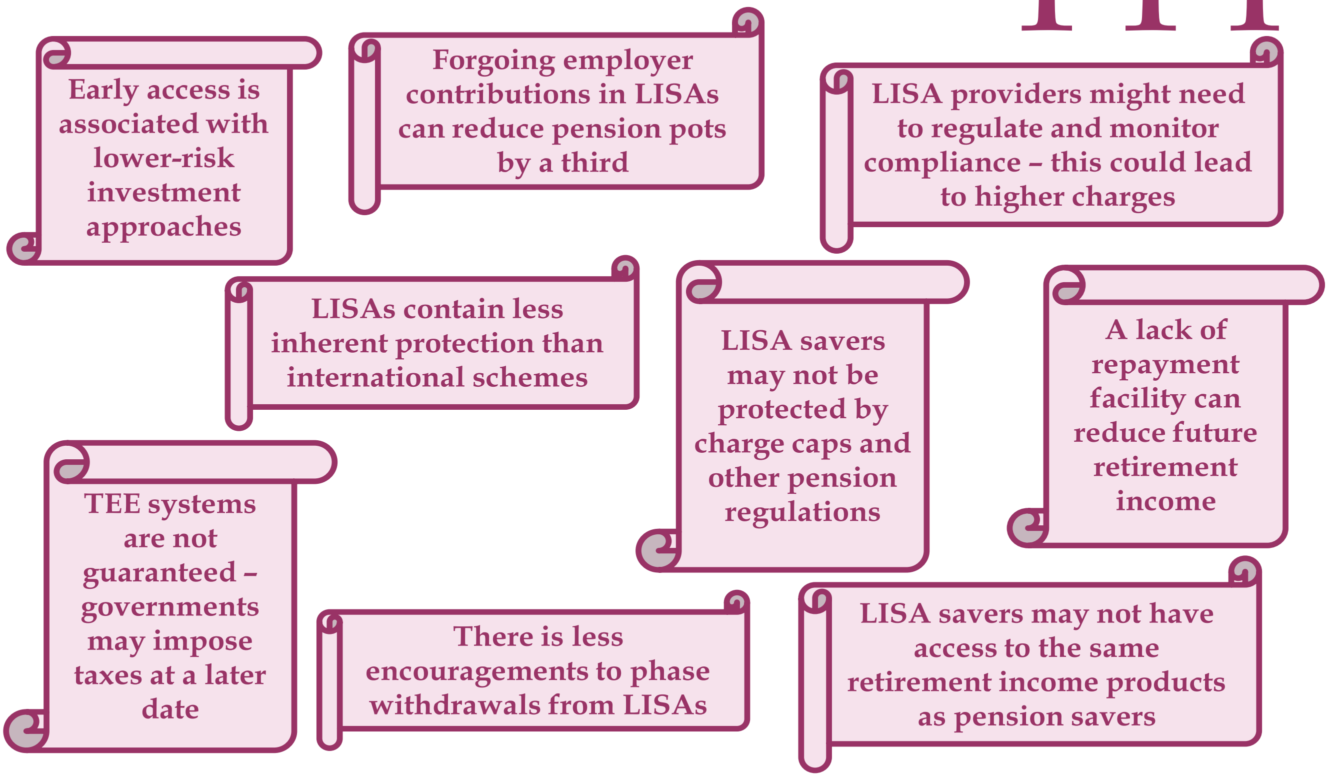
- Eligibility is determined by the pension provider via a self-assessment form filled out by the applicant. Overall use of withdrawals is supervised by the Canadian Revenue department.
- Those who do not make scheduled repayments must pay income tax on any missed payments in the year in which they missed them.
- **Taxation:** Group Registered Retirement Savings Plans are EET.
- **Take-up:** In 2011, around 1.8 million Canadians were participating in the home buyers plan. The proportion of scheme members participating in 1998 was calculated to be around 2%, though it may have changed since then.[12]

Singapore: Central Provident Fund

- **Early access:** Singapore has a single social security pension system, known as the Central Provident Fund (CPF) that is intended to provide a household's retirement income with no further top-up from the state. Participation in the scheme is mandatory for Singaporean workers.
- It is possible for members to withdraw funds to purchase a private property. They are able to withdraw funds of up to 120% of the purchase price of the property.
- When the property is sold, the proceeds will be used to pay back the initial amount taken from the CPF along with any interest the funds would have accrued if they had remained invested (once the mortgage has been repaid).

The next section of this Note outlines key lessons for the UK arising from international evidence (Chart 4).

Chart 4: Key lessons from international evidence for the UK



Implications for the UK

The LISA is a separate product from a workplace pension

The LISA differs from pensions which allow early access in other countries because it is a distinct product from workplace pensions.

In theory it is conceivable that a workplace pension and a LISA could be combined to allow people to contribute to a pension and to a LISA at the same time, providing people the opportunity to contribute to an EET pension, save for a house and provide themselves with a supplementary tax-free source of income in retirement.

However, this policy would require support from employers who are responsible for overseeing employee contributions into workplace pensions. It would also potentially require people to make contributions over the normal minimum required levels of 8% of band earnings (£5,824—£42,385) 2016/17 under automatic enrolment in order to ensure they still had sufficient savings to support needs in retirement.

Employers are not required to contribute to employees' LISA savings

One of the key features of the LISA arrangement is that it requires people who wish to combine pension savings with saving for a house, to choose an alternative savings vehicle to a traditional workplace pension.

The LISA scheme differs from the workplace pension in that it is TEE, but also because employees who take out a LISA are not guaranteed to receive an employer contribution, while most members of workplace pension schemes are.

LISA members are eligible for a matching Government bonus of 25% of contributions (up to a total of £1,000 per year). Members of UK workplace pension schemes are eligible for tax relief on pension contributions at their marginal rate (though tapered for higher earners).

In the countries examined in this note, people are able to use their workplace pension schemes alongside an early access facility. Therefore, they are not required to potentially give up an employer contribution or change tax systems in order to use early access alongside retirement saving. However, it is possible that some employers will offer contributions into a LISA in future.

Previous PPI analysis shows that saving in a LISA with the same investment strategy as a pension can result in pot reduction of a third by retirement as a result of forgoing the employer contribution.[12]

However, LISAs can be tax-effective vehicles for saving for a first-time home purchase.

Many other early access schemes require repayment

Early access schemes in the US, Canada and to some extent, Singapore, require repayment of funds within a certain time period or after particular events. This feature mitigates some of the reduction that withdrawing funds early will have on pension savings, though it cannot mitigate entirely for the loss of returns on compound interest.

Because the LISA scheme does not have a repayment facility, funds lost through early withdrawal are lost entirely, alongside any future returns on compound interests generated on that portion of funds. Therefore, early withdrawal may more adversely affect the pot sizes of those using a LISA to save for retirement than those who repay their funds over time into their pension schemes.

Pension schemes which allow early access may have more conservative investment strategies as a result

There is some indication that early access schemes are linked to more conservative investment strategies. For example, pension schemes in the US which allow borrowing tend to be more conservatively invested than the schemes which do not allow borrowing.

Members of New Zealand's KiwiSaver, which allows early access for home purchase, also select more conservative investments, even when making an active choice. In New Zealand, the default automatic enrolment fund is also relatively conservative.

Investment approaches in other countries are guided not just by member preference but by cultural, economic, market and regulation factors. Therefore, a direct comparison cannot be made.

However, the international evidence indicates that there may be a tendency for those wishing to withdraw retirement savings early to favour a more conservative investment approach. Lower-risk investment approaches are quite likely, over time, to lead to lower returns, though they are better at avoiding short-term volatility. If LISA savers favour lower risk investments, this might reduce the value of their retirement savings over time.

There may be a reduced incentive to withdraw retirement income in a phased way

Schemes in the US which allow early access also require minimum withdrawals after a certain age. These schemes are also EET, meaning that people are incentivised to withdraw a minimum level of income without withdrawing so much that they enter a higher tax bracket.

Canada's system is also EET, incentivising pension members not to withdraw beyond their marginal tax allowance

New Zealand, which allows early access alongside a TTE scheme has traditionally had less concern about the use of private pension funds in retirement due to the more generous state pension.

Because UK private pension savings are EET, there is an incentive to withdraw retirement savings in a phased way, that provides for needs in retirement without incurring excess tax charges. LISA savings, however, are TEE, and therefore people who make retirement savings using a LISA may withdraw large lump sums from their savings in early retirement, depleting savings earlier than if they were withdrawing from private pension savings.

LISA savers might not have the same options for income conversion in retirement

Those who use pension saving products with early access internationally have access to products designed to help convert savings into a pension income. In the UK, there are drawdown and annuity products, designed to work within the pensions tax system and help people to provide themselves with an ongoing income stream with which to support retirement.

LISA savers are unlikely to want to use these products as they are designed for EET savings and income from these products is taxed.

LISA savers may receive less support in choosing an appropriate income product as there is likely to be less free advice and guidance on offer than for those retiring with private pension savings unless the system evolves to provide more support.

LISA savers might not be protected by the same regulation regime as those saving in a workplace pension

In the UK, private pension schemes are regulated by a combination of The Pensions Regulator (TPR) and the Financial Conduct Authority (FCA).

With the advent of automatic enrolment, regulatory reforms have been introduced with the aim of protecting the interests of savers in private pension schemes. Notable among these reforms are the charge cap on default funds in automatic enrolment qualifying schemes of 0.75% (excluding transaction costs). Providers of contract-based schemes are also now required to answer to Independent Governance Committees, whose role is to ensure schemes provide value for money to members.

The Government also provides free pensions guidance for those approaching retirement with Defined Contribution pension savings, which may not be offered to those approaching retirement with LISA savings.

Other countries combine early access with recognised private pension schemes, subject to the pension regulatory regime.

People who save in a LISA, will most likely have their providers regulated by the Financial Conduct Authority alongside other users of non-pension financial products, and would not have their scheme regulated by The Pensions Regulator through their employer and automatic enrolment regulations. They are unlikely to benefit from the special measures which have been put into place in order to protect those saving in private pension schemes. This could have a particular impact in the area of charges. Higher charges can erode the value of a pot over time by around 13% (0.3% vs. 1%-1.5% charges).[13]

LISA providers might need to monitor eligibility and compliance with early withdrawal regulations

In the other countries examined here, the early access facilities are generally administered and regulated by a combination of the scheme provider/sponsor and the Government.

If LISA providers are responsible for assessing the eligibility and tax positions of members who wish to withdraw early, this could create an extra administrative burden which may result in higher costs to the saver.

Tax exemptions in TEE systems is not necessarily guaranteed

One of the benefits of TEE schemes is that provides certainty around the amount of money that will be available during retirement, as none of the fund will be eroded through tax charges.

However, the situation in Australia indicates that if people are seen to be taking too much tax-free income in retirement, the Government might attempt to recover some portion of that income through new tax rules which dilute the exempt status of pension withdrawals.

1. Mercer (2014) *Post-retirement market trends in Australia*, p.3

2,3,4 Financial Markets Authority (2015) *KiwiSaver Annual Report*, p.14,18-19

5. Investment Company Institute (2015) *2015 Investment Company Fact Book*, p.152

6. Aon Hewitt (2015) 2014 *Universe Benchmarks*, Forbes, August 19 2014, *"Employees are falling for Roth401(k)s"*

7. Lu et al. (2014) *Borrowing from the future: 401(k) plan loans and loan defaults*, Pension Research Council, Pennsylvania USA, Bloomberg, June 15, 2015, *"Are You Missing Out on the Roth 401(k)?"*

8. Investment Company Institute (2015) *2015 Investment Company Fact Book*, p.156

9. Ameriprise Financial (2014) *Financial trade-offs study;* Mitchell, O.S. *(2014) "Borrowing from the Future: 401(k) Plan Loans and Loan Defaults,"*

10. Aon Hewitt (2015) 2014 *Universe Benchmarks*, p.2

11. www.canadianmortgagetrends.com/cana-dian_mortgage_trends/2013/02/disappointing-new-stats-on-the-rrsp-home-buyers-plan.html, Frenken, H (1998) *The RRSP Home Buyer's Plan*

12. PPI (2016) *Briefing Note 81 Lifetime ISAs: pension complement or rival?*

13. PPI (2012) *Closing the gap: the choices and factors that can affect private pension income in retirement*

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