DC Briefing.

Will LISAs win the hearts and wallets of the young generation?

It's been two months since Chancellor George Osborne announced the new Lifetime ISA, or 'LISA'. Will it be viewed just as another complicated structure for the lucky few, or does it have the potential to revolutionise long-term savings?

Veronica Humble – Senior Investment Strategist

In this edition of DC Briefing, LGIM's Veronica Humble, Senior Investment Strategist, examines the new LISA and assesses where the truth may lie between these two opposing perspectives.

It is encouraging to see a long-term savings vehicle specifically targeted at today's younger workers. Unlike previous generations, few under the age of 40 are eligible for a final salary pension[1], and the majority will need to rely on their defined contribution pension and personal retirement savings for their income in retirement.

LISAs could be appealing to younger, more flexible workers, with the potential to become instrumental in increasing the overall level of long-term savings. However, employer contributions mean that a workplace pension arrangement is still the more beneficial savings vehicle.

LISA or workplace DC pension?

Although it is easy to start comparing LISAs to a workplace DC pension, the two options are not necessarily competing for savers. A significant proportion of those under 40 don't have access to employer contributions in a workplace DC scheme. This includes:

- **Self-employed:** There are over 4.6 million self-employed people in the UK[2], with just over a third of those under 40. Very few of them have any sort of pension arrangement
- **Stay-at-home parents:** This group is often overlooked in standard pension projections, where a full 40 or 45 years of pension contributions is often assumed. The reality is very different: economic inactivity amongst women aged 25-34 is 22% as opposed to 7% for men[3]. Even if the time out of work is temporary, it leaves a gap in long-term savings or private pension provision
- **Members of DB schemes:** There are also 2.7 million members of public and private DB schemes[4]. Although one can argue that DB members are not the target audience since they generally have a generous pension arrangement already, the benefits for the younger generation are often much lower than they used to be. In the absence of employer contributions, those who consider paying additional voluntary contributions into a money purchase scheme may find the flexibility of a LISA attractive[5]

The above categories make up over 5 million people. For the majority of these individuals, a LISA may provide an additional incentive to save. It may also compare favourably to existing SIPP schemes. For 20% (basic rate) taxpayers, it is a more flexible savings vehicle that is effectively income tax exempt both at the time of contribution and come retirement, whereas for those in the 'saver' income tax bracket, there is an explicit 25% top-up from the government.

[1]Only 21% of individuals under 40 are members of a DB pension, compared to 36% of 40-49 year olds and 39% of 50-54 year olds. (Source: LGIM calculations from Annual Survey of Hours and Earnings (ASHE), Office for National Statistics ONS, 2016)

[2]ONS, UK Labour Market: April 2016

[3,4]ASHE, ONS, 2016, LGIM calculations

[5]LISA contributions will be subject to national insurance, but will not count towards the Lifetime Allowance or the yearly limit on pension contributions

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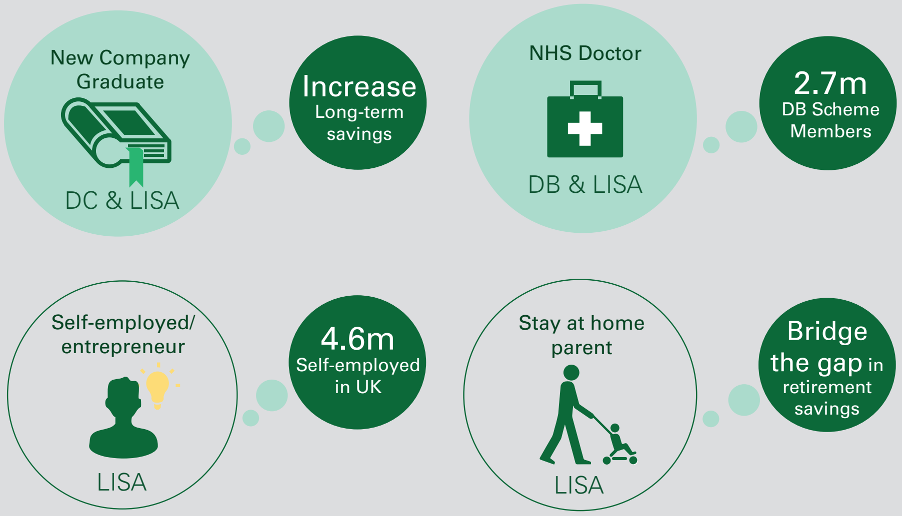
LISA or workplace DC pension?



LISAs may be more attractive than they first appear

Lifetime ISAs have two major features that younger savers may find particularly appealing: the ability to use the funds towards the purchase of a first home, and the ability to access LISA savings before retirement.[6] This flexibility may increase the feeling of ownership and incentivise people to save more.

The psychological attraction of LISAs is easy to underestimate. Whilst the 25% government 'top-up' with LISAs is effectively the same benefit in monetary terms as 20% basic rate tax relief with non-salary sacrifice pensions, it implicitly sounds more appealing. Individuals could be more attracted to the idea of receiving a 'free' top-up on their savings rather than 'just not paying income tax' on whatever they choose to save. We believe that this behavioural attraction of LISA saving could potentially prove hugely significant in encouraging people to put money away for their futures.

Tax considerations in choosing between different savings vehicles become quite complicated. One needs to take into account not only current and likely future income tax rate bands, which depend on overall current and future income levels, but also national insurance contribution rates and the way the pension contributions are structured. [7] Even assuming that the tax treatment will not change over time, it is not obvious which of the vehicles will be more beneficial to a basic rate tax payer. The simplicity offered by LISAs may prove popular.

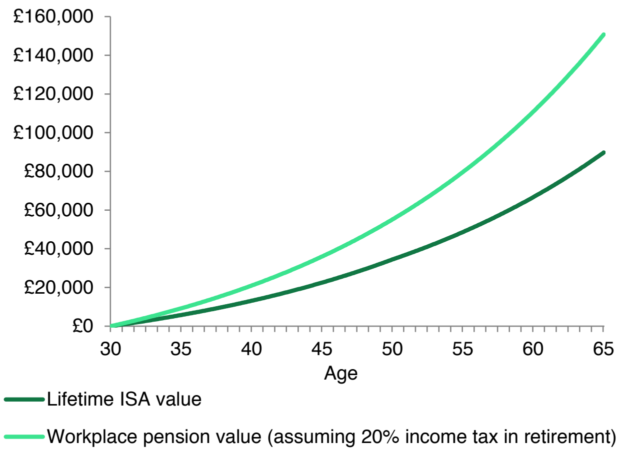
The power of company contributions

Due to the success of auto-enrolment, the majority of private sector workers now have access to a workplace DC pension scheme. Employer contributions can make saving into company DC schemes more attractive than saving into other vehicles.

By way of example, let's take a 30-year old earning an annual salary of £24,000 who is looking to save 5% of their monthly salary towards retirement. This 5% contribution might typically be supplemented with a 3% employer contribution. This will be equivalent to £160 (£100 from an employee and £60 for an employer) in the workplace DC scheme. Assuming a 5% annual rate of return, a marginal tax rate of 20% in retirement (that is, the same as in employment), and the 25% tax-free lump sum accessed at retirement, this level of monthly contribution could lead to a post-tax pension pot value worth over £150k at age 65.

If the individual invests via a LISA, the equivalent monthly contribution (i.e. keeping their income the same after tax, national insurance and retirement savings contributions) is £68. This would then be topped up by the 25% government contribution to £85 for each year until 50, and lead to a pension pot worth nearly £90k at age 65. Although the LISA pot is entirely tax free at this point, the workplace pension pot is still best placed to deliver the highest after-tax retirement income, being worth almost 1.7 times the value of the LISA pot thanks to the power of company contributions and salary sacrifice scheme savings.

Figure 1. The power of company contributions



Source: LGIM calculations. For illustrative purposes only.

[6] Albeit subject to the forfeiting of the government top-up and a 5% charge

[7] On the one hand, although a 25% government top-up on LISA is equivalent to 20% tax relief, workplace pensions may be taxed in retirement, and the level of this tax depends on the level of government pension, DB pension and other benefits. Provided the current rates don't change, the majority of basic rate tax payers are expected to pay 20% or lower, but taking into account the 25% tax-free cash entitlement this will mean 15% or lower. On the other hand, if the workplace pension contributions use salary sacrifice, this will typically mean another 12% tax relief on these contributions that is otherwise paid in national insurance. This tax relief will not apply for LISAs.

LISAs have their own potential risks

Putting the potential benefits of LISAs aside for a moment, we believe their introduction is not entirely without its challenges. Some potential risks that may need to be addressed are:

- **The increasing complexity of lifetime savings:** By introducing a new savings vehicle, the government risks adding another layer of complexity to what is already a highly fragmented savings industry. Given the fact the auto-enrolment is now starting to gain real traction in encouraging people to save into a pension, this should be handled carefully
- **Employees opting out of a company pension:** One of the risks coming from such complexity is that some may be tempted by the flexibility of a LISA and choose to opt out of a company pension as a result. This could leave them worse off in the long-run if they miss out on company contributions
- **Lifetime savings 'leakage':** If the LISA becomes a major part of retirement savings, then due to its flexibility many may tap into their pot before retirement. Their overall level of savings in later life could therefore be affected. This is a known problem in the US, where individual retirement savings accounts (IRAs) and 401(k)s are similar to LISA in their flexibility. The Center for Retirement Research at Boston College estimates that due to this 'leakage', aggregate 401(k) and IRA retirement wealth in the United States is at least 20% lower than it might otherwise have been[8]
- **Tax efficiency:** LISAs don't necessarily enjoy the same favourable tax treatment that many pension funds do. For example, dividends paid from US stocks held in ISAs will typically be subject to a 15% withholding tax, whereas institutional pension fund wrappers pay 0%. This factor alone means that investors in company pension funds can potentially enjoy a significant saving[9], particularly over the long term

LISAs: a welcome addition to the savings landscape

Despite increasing complexity and the potential long-term risks of greater savings flexibility, we believe that the introduction of the Lifetime ISA is a welcome addition to the savings landscape, and wholly agree with the principle of encouraging the younger generation to save more. Whether they are wishing to save towards their first home, or just looking for a long-term savings vehicle that they can tap into if need be, the LISA has obvious attractions that may well win the young generation's hearts, particularly of the self-employed, more mobile generation.

When it comes to voting with their wallets, however, the young should perhaps not view the LISA as a replacement for their workplace pension. Following the recent introduction of auto-enrolment, most workplace scheme savers not only get up-front income tax relief that is directly equivalent to the government's LISA 'top-up',[10] but they can also enjoy a long-term savings boost from higher levels of employer contributions.

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[8]Munnell, Alicia H., and Anthony Webb. 2015. The Impact of Leakages from 401(k)s and IRAs. Center for Retirement Research at Boston College. CRR Working Paper 2105_2

[9]With over 50% of the average global equity fund investing in US equities and the dividend yield on the US stocks typically being over 2%, a typical workplace pension invested in global equity index fund will enjoy tax savings of 0.15% p.a.

[10]For salary sacrifice there is also national insurance relief

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