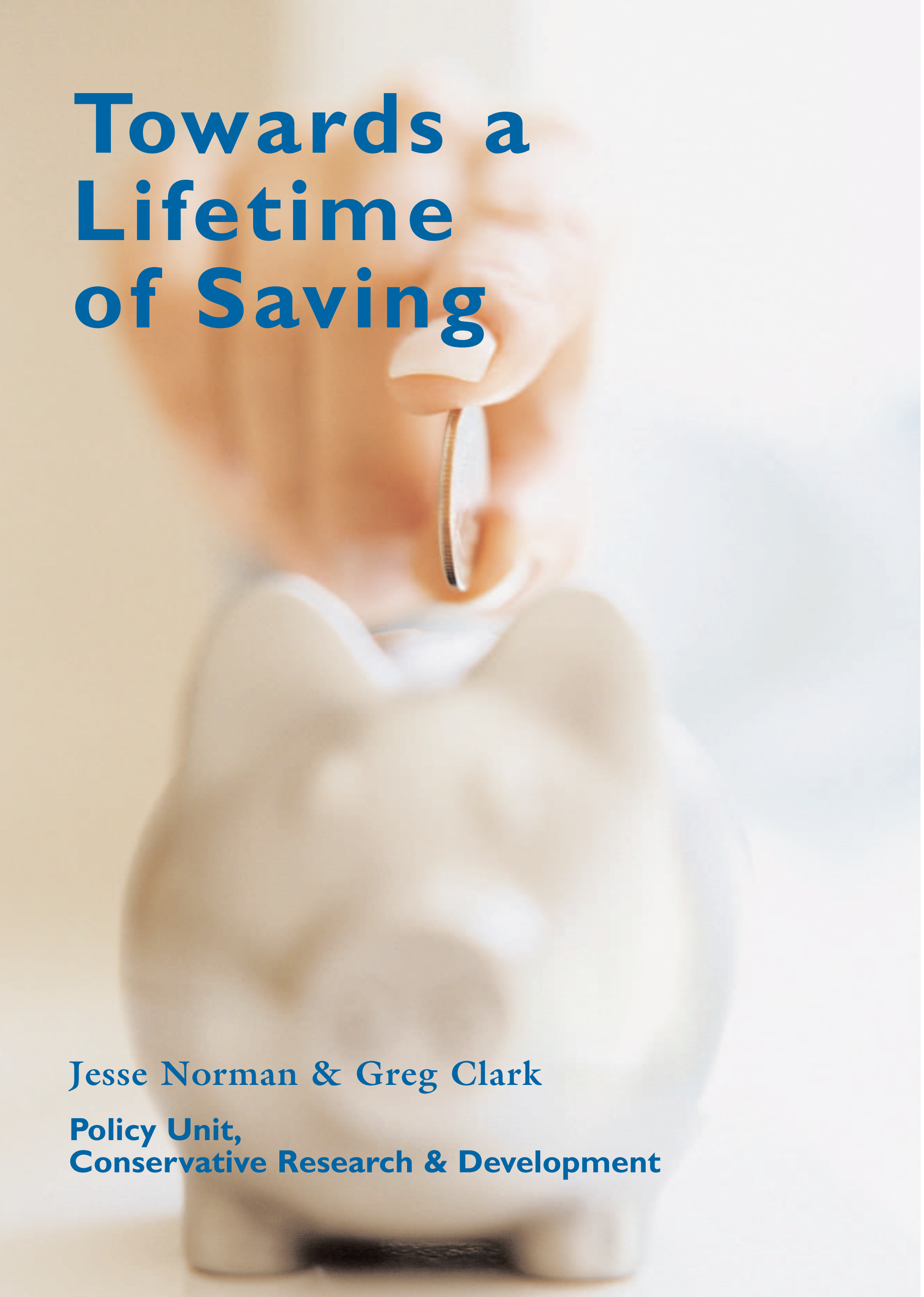
Towards a Lifetime of Saving



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TOWARDS A LIFETIME OF SAVING Jesse Norman & Greg Clark

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This paper describes a radical new savings policy idea, the Lifetime Savings Account. It is part of a consultation process being conducted by the Conservative Party over the Summer of 2004. All recipients of this paper are invited to contribute this consultation process. To do so, please send your submission in writing by 10 September to the Policy Unit, CRD, Conservative Central Office, 25 Victoria Street, LONDON, SW1H 0DL or by email to LiSAconsultation@conservatives.com.

Foreword: by David Willetts MP, Shadow Secretary of State for Work and Pensions

Savings matter, both for a happy working life and for a comfortable retirement. But the amount we save has fallen since 1997 – from 10% of household income to 6% now. We have a severe savings shortfall.

More specifically, in the UK we face two paradoxes about saving:

- ❖ It is far easier to borrow than to save. There are several major disincentives to saving, especially for the less well-off. The present Government's policies aren't helping. In fact, as this paper shows, in some ways – notably through the growth of means-tested benefits – they are actually making things worse.

- ❖ As the savings ratio has fallen, the nation has found itself in a vicious circle. Lower household savings leads to higher spending on means-tested benefits, which provides a further disincentive to saving, hence more means-tested benefits, and so on.

Together with my colleagues, I have been developing a new savings policy idea specifically designed to encourage savings growth across the age and income spectrums – the Lifetime Savings Account (LiSA). The LiSA is an extremely simple savings account, which matches each individual's savings with cash. The principle might be what food retailers call BOGOF – Buy One, Get One Free.

The LiSA is not means-tested, and it is extremely flexible, allowing people to build up long term capital. We can use the LiSA to rebuild the nation's savings and break the vicious circle of under-saving and benefits disincentives.

This paper is designed to launch a consultation process around the LiSA. We want to have feedback from as wide a range of constituencies as possible. We would be very grateful for any comments you have.

David Willetts MP

1. Executive Summary

Saving creates personal wealth, and can give the saver real freedom, confidence and independence. Yet there are large embedded economic disincentives to saving in the UK, which particularly affect those on lower incomes. As a result, the amount households save has fallen significantly, and the less well-off in particular have very low levels of financial saving.

The present Government has recognised the problem. Yet none of its many policy initiatives – including ISAs, the Child Trust Fund and Stakeholder Pensions – is well-designed to address it. All rely on the use of tax incentives or means-testing, or both; these and other features render them ill-suited to the task.

A particular issue concerns the inflexibility of current savings products. Many people are put off from long-term saving by pension rules, which can require them to lock up their money for decades – money they may need in the meantime for their homes, their families, or for a rainy day.

The Lifetime Savings Account ("LiSA") directly addresses these concerns. It is a very simple and general long-term savings vehicle. It is not means-tested; it uses matching payments in cash as an incentive to save; it is easy to implement; and it is complementary to existing products and savings initiatives.

Crucially, it is highly flexible. It offers savers a new kind of savings product, which both allows and encourages them to use short-term savings to build long-term capital. If the matching principle were BOGOF – Buy One, Get One Free – then this would further underline the simplicity and value of the LiSA itself.

This paper describes the problem of low savings, analyses the strengths and weaknesses of existing Government savings initiatives, and reviews the evidence for the value of cash incentives. It then sets out the LiSA in detail. In the final section, it poses a number of key general and specific questions for consultation.

2. The Problem of Low Savings

Why Save?

The UK, at the start of the 21st Century, is a country of consumers. The shops are full of an ever-growing range of products, advertisements fill the media, and shopping is a national pastime. We expect to be able to buy things whenever and wherever we want, promptly and at competitive prices.

Ours is largely a culture of consumption not of saving: of the immediate purchase of assets on credit rather than the slow and incremental accumulation of wealth. In this context, the very idea of saving can seem quaint, if not irrelevant.

Why should people save? Of course, it is important for the economy that there be a sufficient stock of savings. But, just to focus on the benefits to the saver, we can identify two major reasons why people should save:

- Lifecycle needs: this includes saving for specific purposes, such a deposit on a house or a period of education or training; and “rainy day” saving, to meet unexpected financial difficulty, for example.

- Retirement needs: to provide a secure and comfortable income for old age.

Savings also have other benefits, however. Savers can plan and organise their lives better. They can set themselves fulfilling goals, confident in the knowledge that they can ride out temporary setbacks along the way.

And there is a long tradition that links the habit of saving with the virtues of thrift, frugality and patience; and, more recently, with those of autonomy, independent-mindedness and enterprise.

People generally have both lifecycle ***and*** retirement savings needs. It is one of the oddities of present Government savings policy that it does not support the creation of flexible savings products, which combine instant access with long-term retirement incentives. Yet there is no necessary reason why this should be so, as we shall see.

The Problem of Low Savings

Saving should be encouraged. But we often hear talk of a national savings problem, even a "Savings Crisis" in the UK. Many people believe that the UK population does not save enough to provide for either its lifecycle needs or its retirement needs.

Overall, the UK Household Savings Ratio (that is, the proportion of household income saved) has fallen from 10% in 1997 to under 6% now (ONS 2004); and – though the comparison should be treated with caution – the UK rate has been significantly lower over time than those in several other leading OECD countries (see Table 2.1).

Table 2.1: Household Savings Rates, 2002 (%)

US	2.5%
UK	5.5%
Canada	13.6%
Germany	9.6%
Japan	9.6%
France	11.1%
Italy	9.5%

Source: OECD 2004

Lower Income Savers

Within this general picture of lower saving, some groups save more than others. An important specific problem concerns the apparently low levels of savings among people on lower incomes. By "people on lower incomes", we mean those below the halfway mark in household income – but not the very poorest, who generally need all their income for current consumption. This target group includes approximately 10 million households at present. But it includes a much larger group over time. Many – indeed, almost all – of us have lower incomes at some point in our lives, whether it is people in their first job, a parent changing to work part-time when children are young.

Specific and up-to-date financial information about those on lower incomes is hard to come by. But it does appear that they save very little. For example, in 1998 the median level of household wealth held in financial assets was only £750, with 11% of families having no financial assets at all, even a current account (IFS 1999).

Encouraging those on lower incomes to save has long been a goal of Government savings policy. But, against this, it might be argued that this goal is misplaced. If all people are basically economically rational, one such argument runs, the low levels of savings among those on low incomes must merely reflect a set of economic decisions by those on low incomes not to save. There is no market failure here. If one further believes that Government intervention in the savings area should be to address cases of market failure, then there is no basis here for Government to intervene.

Disincentives to Saving

Unfortunately for this argument, there are several large economic and cultural disincentives within the UK savings environment itself. Put simply, it is difficult to save; and it is especially difficult to save for those on lower incomes.

- In the first place, the savings market is diverse and complex. But the counterpart of this appears to be that some people find the subject of savings hard to understand, and feel little motivation to learn about savings.

- Secondly, the present economic environment is one of low inflation, and hence of low nominal interest rates. It appears that many people ask: why bother to save when you can only earn 2–4% on your money?

- Thirdly, the disposition of the general population to save has been greatly weakened over the recent past by other factors, including concern at high bank charges, financial scandals and failure, the dot-com boom and bust, and the generally weak performance of the equity markets since 2000.

And there are three further disincentives that particularly affect those on lower incomes:

- At present the tax system is widely used to encourage savings. But those on lower incomes pay relatively little tax, and so do not greatly benefit from tax relief; as a result, many believe that tax breaks are irrelevant to them. There is also some evidence that "tax" has negative associations for some savers even in the context of tax relief; and that "lack of understanding of tax-related issues is more acute amongst lower-income groups" (Sandler 2002). Understanding tax issues often requires advice, of course, and advisers are less likely to serve those on lower incomes, for economic reasons.

- Moreover, pensions – the principal long-term UK savings vehicle – generally prevent savers from gaining access to their savings before retirement, say in case of a "rainy day". This discourages savers generally from putting short- or medium-term savings into their pensions. It particularly affects those on lower incomes, who tend to have more rainy days than those who are better-off.

❖ Finally, and crucially, the UK benefit system itself gives a major disincentive to household saving, through the use of means-testing:

- Short-term savings are discouraged by such programmes as Income Support and Housing Benefit. Income Support, for example, is not payable to individuals under 60 who (with a partner) have more than £8,000 in savings; and it steadily withdraws benefit from those with between £3,000 and £8,000. Only those with less than £3,000 escape withdrawal of benefit altogether (DWP 2004). In 2002–3, approximately 4 million people received Income Support, underlining the size of the affected groups (IFS 2003b).

- As regards long-term saving, the effect of Pension Credit is to discourage private savings (Willetts and Yeo 2003). Why bother to forgo spending during your lifetime and save, if you are at best little better off than if you had spent it all and qualified for Pension Credit?

Implications for Policy

Some of these disincentives – such as changing expectations and levels of trust – derive from the basic facts of economic life. It is hard to see how Government could make a difference here. But other disincentives are clearly and properly addressable by Government. This suggests that Government policy towards the encouragement of savings for those on lower incomes should stress simplicity, clarity, flexibility and stability; and that where possible, it should remove tax and benefit disincentives to save.

3. The Limitations of Current Government Policy

Introduction

In addressing issues of savings policy, we can start by asking two questions: What is the Government already doing to encourage savings, especially for those on lower incomes? And: What differentiates a successful savings vehicle from an unsuccessful one?

We need to include pensions in the discussion here in order to get a clear overall view. Since 1997, the Government has implemented an enormous body of savings-related legislation. But from this we can identify three key current initiatives: ISAs, The Child Trust Fund, and stakeholder pensions.

In fact, however, each of these products illustrates the weakness of some aspect of current Government savings policy:

- ISAs show the limitations of tax relief
- The Child Trust Fund shows the limitations of means-testing
- Stakeholder pensions show the limitations of Government intervention in product design

ISAs: The Limitations of Tax Relief

ISAs are a flexible and open-ended savings vehicle, and have proven successful since their introduction in 1999. But they only use tax relief as a means to encourage saving, and this restricts their overall attractiveness to savers. Those on lower incomes pay little income tax, and hardly any capital gains tax: specifically, less than two-thirds of the adult population of the UK have high enough incomes for them to pay Income Tax at all; and only 80,000 people pay Capital Gains Tax (IFS 2003). Moreover, we saw evidence in the last section that levels of understanding of financial products, and the tax system in particular, are less among those on lower incomes. This implies that ISAs are less relevant to this target group than to those on higher incomes.

Nevertheless, cash ISAs have proven a relatively useful savings vehicle among those on lower incomes; and this is of great interest from a policy perspective. It seems to suggest that people across the income spectrum will save, even if the benefit conferred is modest and imperfectly understood, when the basic savings proposition is a simple and flexible one.

The Child Trust Fund: The Limitations of Means-Testing

We have already noted that the effect of means-testing for benefits such as Income Support and Pension Credit is generally to reduce the incentive to save. In some cases the impact can even be confiscatory – to reduce a modest saver’s total income to below the level he or she would enjoy if they had never saved at all.

The Child Trust Fund or "Baby Bond" offers parents the opportunity to build up an individual pot of savings for each child. In policy terms it is a hybrid, combining a means-tested upfront cash payment with an annual tax relief incentive. The independent Institute of Fiscal Studies (IFS) has shown how, as with means-tested benefits generally, the CTF is likely to miss its target population, in two ways: failing to include some groups which should by rights be receiving it, while being available to others which arguably should not be saving, i.e. the unemployed and the least well-off (IFS 2001).

There are other reasons why means-testing is often unattractive as a tool of social policy. These include the apparent stigma felt by many of those who do accept means-tested benefits; the intrusiveness of Government inquiry into people's private savings; the fact that means-testing encourages its recipients to gain knowledge of the UK benefit system, rather than financial education as such; and the very high cost-per-benefit and associated bureaucracy of administering the means test itself.

Stakeholder Pensions: The Limitations of Government Intervention

Stakeholder pensions were introduced in 2001 as a low-cost and portable long-term individual savings vehicle, to be sold mainly through companies, and specifically aimed at those on lower incomes. All companies with no pension arrangements, even very small ones, were accordingly required to put in place stakeholder pension schemes, at significant cost; while a 1% cap was placed on product charges.

Unfortunately, the consensus seems to be that, so far at least, stakeholder pensions have been a failure, with falling sales figures and low utilisation (ABI 2002, 2003b). Why have stakeholder pensions not succeeded? The Government's combination of compulsion and fee capping has not been a happy one: it has had the effect of imposing costs on companies even where there may be little or no declared interest in stakeholder pensions among their employees; and, at the same time, it has inhibited the profitability of the product to financial providers, thus deterring them from marketing and innovating – in this case, during the crucial launch phase of the new product. It is plausible that a more open and non-interventionist approach would have fared much better.

Conclusions

The main policies of the present Government have significant limitations as a framework for encouraging saving across the population as a whole. ISAs and the CTF rely on tax incentives, or means-testing, or both. The experience of stakeholder pensions, on the other hand, reinforces the view that it is not for Government to be engaged in top-down product design or specification of charges as such.

4. Key Savings Drivers: Flexibility and Cash Matching

Let us briefly take stock. We have seen that there is a general problem of low saving in the UK at present, and a specific problem of low savings among the less well-off; and that there are serious economic disincentives to saving. We have also briefly reviewed some key current savings initiatives, and noted their limitations.

What can we learn from this? What are the key drivers of a successful savings vehicle?

Key Driver 1: Flexibility

The first driver is flexibility. Saving is not just about retirement – it's also about lifecycle needs, such as buying a house and starting a family. We have noted that savings products tend to support one goal or the other, but not both. As a result, many savers face a liquidity trap: they do not save, because they do not want to lock their "rainy day" savings away over the long term.

But a habit of building up short-term saving can be crucial to having enough long term savings. A savings vehicle should follow what we might call the "Marks & Spencer" principle: that in retailing people will buy more if they know they can always bring it back if needed. In practice, however, most people end up keeping what they have bought – it is the option to get your money back that is important.

Similarly, people will save more if they know they can always get hold of their savings if needed: savings should go with the grain of their lifecycles, and not remain static. ISAs, for example, allow savers to withdraw their money as and when they need. But ISAs have the drawback that they can't be re-used. So the saver has no incentive to put money he or she has withdrawn back into the account.

Moreover, there is little reason to think that short- and long-term incentives cannot be combined into a single whole. The retail financial services marketplace has seen a proliferation of ingenious products in recent years, combining accessibility and long-term incentives in various ways. An offset mortgage is an example, allowing cash savings to be netted off against long-term debt.

Flexibility is also crucial in another way. Again, the example of ISAs is relevant: their success underlines the importance of having an open-ended legal framework within which innovation and competition can flourish.

Key Driver 2: Cash Matching

We have also noted tax relief has limitations as an incentive to saving amongst people on low incomes. Can we do better for this group? An increasing body of evidence suggests that matching cash payments could be significantly more effective than tax as a means to encourage savings. This evidence includes data both from programmes in the field, and from surveys.

Individual Development Accounts: the US Experience
The longest and most detailed evaluation of this topic is an American study of "Individual Development Accounts" or IDAs (CSD 2002): cash-matched savings accounts for those on low incomes. After surveying 14 different IDA programmes from 1997–2003, the study concluded that participants on low incomes had significantly improved both the amounts and frequency of savings; and that savings rates were improved by higher match rates (greater than 1:1), by the use of direct deposit arrangements, by a previous history of asset ownership by the saver, and by the provision as part of the savings programme of a fairly small amount (1–8 hours) of general financial education.

The Savings Gateway
This is supported by some recent findings from an interim review of the "Savings Gateway". The Savings Gateway is a short-term (18 month) means-tested account, in which the account-holder can save a maximum of £25 per month, or £375 over the life of the account. On maturity, the Government will pay in to the account a contribution matching any funds saved on a £1:£1 basis. Entitlement to the Government match builds with every amount saved, but no match funds can be withdrawn before maturity. No interest is paid. Savers' own funds can be withdrawn, but the match stops, and does not resume until the withdrawn funds are repaid.

The Savings Gateway is currently being piloted in five areas in England. An interim review was conducted at Bristol University in October 2003 (PFRC 2003). Its initial findings broadly support the IDA evidence: there was a significant increase in the levels and frequency of saving by participants; an apparent net increase in saving, rather than pure transfers from existing funds. Most notably, cash matches were regarded by participants as a far more effective incentive than alternatives such as bonus payments, tax relief, and higher interest.

Survey Data

Two important recent surveys conducted on behalf of the Association of British Insurers offer strong further support for the value of cash matches as incentives:

❖ The first surveyed 851 individuals earning £10–30k p.a. (ABI 2002b). Of these, 54% said a 50p:£1 cash match would make them "very likely" to save more; 33% said they would be "fairly likely" to do so.

❖ The second, in 2003, surveyed 3,565 adults of working age, weighted by age and gender profile of working UK population (ABI 2003). Of these, 60% preferred a 50p:£1 cash match to tax relief, increased pension contribution and early pension withdrawal.

These are very striking findings. *Eighty-seven percent told the first survey they were very or fairly likely to save more if offered a cash match.* And cash matching was by far the most popular of the four alternatives on offer in the second.

The overall evidence suggests, then, that matching cash payments can be effective as a means to encourage people to save; that they are more psychologically effective as an incentive than tax relief especially to those on lower incomes.

5. The Case for the Lifetime Savings Account

The Lifetime Savings Account (LiSA) is a radical new savings idea. It is designed to meet all the goals we have so far identified for a savings policy. Specifically, the LiSA:

- ❖ Is extremely simple, clear and flexible
- ❖ Supports both lifecycle and retirement savings
- ❖ Uses cash incentives
- ❖ Is a wrapper, not a product
- ❖ Fits well with existing savings initiatives

Some detailed thoughts on the workings of the LiSA can be found in the Appendix.

Simplicity and Flexibility

The basic idea of the LiSA (the "Cash LiSA") is exceptionally simple:

- ❖ It is an interest-earning deposit account, available to everyone over 18.
- ❖ Every year the Government matches each £1 of your savings with a further amount in cash, up to a given cap. (The annual cap amount would be upgraded

over time broadly in line with inflation.) The principle might be BOGOF: Buy One, Get One Free. This is well-understood by all.

- So every year, including interest, you can put away a meaningful sum in savings, a portion of it Government money. You can save more if you want, but only the amount up to the annual cap qualifies for the Government match.

- Both your money and the Government match earn interest at normal commercial rates. All interest accrues within the two accounts.

- You can take ***your*** money out (including interest) whenever you like. But if you replace the withdrawn savings quickly, you can also keep your entitlement to all or much of the matched amount you have built up.

- On or after retirement at 65, or perhaps in the event of chronic illness, you can also withdraw the total Government matched amount, including all interest on the match, as a lump sum. If you die, your beneficiaries would receive the lump sum.

- There would be no restriction on the use of the Government match lump sum. In many ways it would also be desirable for amounts in the LiSA to be ignored for purposes of calculating Government benefits.

This is the Cash LiSA. But the LiSA wrapper can in principle include a wide range of other products, including bond and equity products, as described below.

Supporting both Lifecycle and Retirement Saving

The LiSA gives savers the ability to build up substantial sums over time, both for their lifecycle needs and for retirement. It encourages individuals to save for their short term needs, and ***in so doing*** to save for their retirements.

Table 5.1 shows the lump sum (saver's money plus match) built up in a Cash LiSA after given periods of time. We have assumed an average gross interest rate of 5%, credited net of tax. We have also assumed that the saver's contributions and Government contributions rise in line with inflation every year, which we assume is 2%. For the sake of simplicity, it and the other examples below assume that all matching is £1:£1, i.e. follows the BOGOF principle

Table 5.1: Indicative Cash LiSA Lump Sums (£)

	5 years	*10 years*	*20 years*	*30 years*	*40 years*	*47 years*
£10 p.m.	£1,378	£3,198	£8,631	£17,528	£31,738	£46,285
£15 p.m.	£2,067	£4,797	£12,947	£26,292	£47,607	£69,428
£20 p.m.	£2,756	£6,395	£17,263	£35,056	£63,476	£92,570

The LiSA meets key lifecycle and retirement savings needs, as these examples illustrate

❖ *LiSA Lifecycle Saving*. The numbers above are for individual LiSAs. So a couple who saved as little as £20 per month (uprated with inflation) each and every year from age 20 and did not withdraw any savings, could put down a deposit of nearly £6,400 on a house at age 30.

- *LiSA Retirement Saving*. At or after age 65, LiSA savers can withdraw ***both*** their own savings ***and*** the match amount as a lump sum. So someone who started a LiSA at 18, and who saved as little as £20 per month every year and did not withdraw any savings, would receive a total of nearly £100,000 at 65. A couple would receive almost £200,000

The inclusion of equity products within the LiSA wrapper could potentially improve long term returns significantly. The average real return on equities over the past 50 years has been 6.9%, compared to 1.6% for Gilts and 1.8% for cash (Barclays 2004). Thus the LiSA lump sum would be greatly improved by investing the Saver's Account in equities at this historic rate of return.

Cash Matching

The LiSA encourages saving through matching cash payments. So it avoids the limitations of tax relief for the low paid as an incentive, which we noted earlier. In practice, those who pay income tax would see their tax bill reduced. While those who do not would still receive a payment although we would not envisage those on very low incomes to be significant savers.

The LiSA thus provides a meaningful and repeated incentive for everyone to save. The annual availability of the cash incentive encourages those who are dipping into benefit to save into their LiSA in times of plenty, without penalising them in times of need.

The LiSA would, then, be a very attractive savings vehicle to those on lower incomes. But the LiSA would also be attractive to those further up the income scale, many of whom could be expected to subscribe every year up to the annual match amount via direct debit.

A Wrapper, Not a Product

So far we have been discussing the basic model, an all-cash matched account, which we can call the “Cash LiSA”. Like an ISA, however, the LiSA is designed to be a wrapper, not a product. That is, it can in principle be used to offer a wide range of fixed income and equity-based products, including “stakeholder” products. These can provide choice, diversification and yield enhancement for the saver.

The LiSA Improves on Current Government Savings Initiatives

The LiSA can also be used to unify and improve on some of the current Government’s savings initiatives.

❖ The Child Trust Fund could be added as the front-end of the LiSA, available to all those from birth to age 18, either as is or with modifications. If as is, then there would be a clear incentive for the saver to use part of the CTF to save in the initial years of the LiSA. An interesting alternative approach, however, would be to rejig the CTF itself to introduce an annual matched saving component. This would correct an apparent weakness in the current CTF – it does nothing to encourage a savings habit by the beneficiary – and it would prepare the saver for the transition to saving within the LiSA itself.

- As noted, it is not yet clear whether the Savings Gateway will be rolled out nationally; and if so in what form. There are some significant differences between the Savings Gateway and the LiSA: in particular, the former is at present a short-term savings vehicle targeted via means-testing and community organisations at the very poorest groups. However, there is no reason to think that the Savings Gateway could not, if desired, be incorporated underneath the LiSA, with savers graduating from the Savings Gateway to the longer-term vehicle as they built up savings. Any double-counting of benefit might be acceptable in relation to the very low-income target groups involved.

High Take-Up

The LiSA is a highly attractive savings vehicle for any potential saver. After an initial period, we should expect take-up for the LiSA to be high.

But not all savers will save in every year, or will save the full matching amount per year. And withdrawal of savings will cause unutilised match funds to flow back to the Government every year (see the Appendix for some thoughts on how this might work in detail).

Overall, the costing of the LiSA is sensitive to several factors: the rate of matching by the Government, the ceiling on Government match contributions, the number of people taking up the product, the level of savings in any given year, the number of years in which saving takes place, the level of withdrawals, and the rate of match flowback for withdrawals.

6. Questions for Consultation

This paper has proposed a new savings vehicle, the Lifetime Savings Account. It is being circulated to a very wide range of possible constituencies, in order to stimulate debate and comment.

What we are seeking now is feedback from you, the reader: your analysis, your ideas and your views. At the most general level, these might concern questions such as whether an approach which encourages individuals to build up their own pots of savings is the right one.

However, there are also ten more specific questions about the LiSA on which we would greatly appreciate your feedback.

1. What is the correct amount and rate of matching payment?

The matching payment should, it seems, try to strike a balance between the rate of matching by the Government (i.e. £1 saved: £1 Government match, or £1 saved: 50p Government match), and the ceiling on the matched contribution (i.e. up to £20 per month, or say, £50 per month).

The lower the ceiling the higher could be the rate of the matching for the same cost to the Exchequer, thereby targeting lower income groups who might find difficulty saving up to a higher ceiling.

The right approach might be tapered: £1:£1 matching for the first £10 a month; £1:50p for the next £10 a month and so on until a ceiling has been reached.

2. How should the matching payments be administrated?

We believe that it is important, particularly for the low paid, to emphasise the matching payments as being in cash. In practice, for most savers the effect of the cash matching will be to reduce the amount they would otherwise pay to the Government. In this case the payment would be regarded as offsetting people's tax bills and be most appropriately administered by the Inland Revenue in conjunction with financial providers. Would this be the best way to proceed?

3. Should the LiSA Match Account be primed with cash?

The present approach has savings matched by the Government at the end of every year. This seems to be the simplest approach.

But would this provide the right upfront incentive to open an account and start saving? Maybe the payment should be front-loaded? Or maybe the LiSA should be primed with an additional starter sum from the Government, to encourage savers to open a LiSA in the first place? This would cost more, however. What do you think?

4. How should withdrawals be handled?

We want the LiSA to be a flexible product, allowing people access to their case, but encouraging them to restore their savings when they are able, if they have made a withdrawal.

But we need to avoid creating a loophole that would allow people to trigger their Government match each year and then withdraw their own money immediately. That way they would never really be saving, but could build up a large Government match entitlement on retirement.

The way we consider best encourages people to restore their savings following a withdrawal is to reduce the Government match account by 10% for every year in which it exceeds the balance in the saver's own account.

Is this the best way to encourage savers to replace withdrawn savings as soon as they can?

5. Should withdrawal of Government match be possible before 65?

At present the LiSA blends short-term and long-term incentives: on the one hand, savers have instant access to their money, rather than locking it away, and they get a matching payment in every year that they save; on the other, the matching funds can only be withdrawn at or after age 65, barring chronic illness or death. The LiSA thus uses lifecycle or "rainy-day" saving to stimulate long-term asset-building by savers.

Should LiSA match amounts be withdrawable earlier by savers? Should it be possible to set up a LiSA after 65, or extend an existing LiSA to, say, 75?

6. Can the interaction of the LiSA with existing benefits be improved?

As noted, it would in many ways be desirable for the LiSA to be ignored in the calculation of Government benefit. There would no disincentive from Pension Credit to saving in a LiSA; and those potentially eligible for means-tested benefit during their working lifetimes would be likely to save heavily in the LiSA, since these savings would not cause them to fail an assets test for receipt of benefit.

Is this approach the right one? Should the LiSA interact differently with different benefits programmes?

7. How should the LiSA relate to other savings vehicles?

The LiSA proposes a very general and simple framework for savings. We have described how the LiSA might include existing Government savings programmes such as the Child Trust Fund or Savings Gateway. A further extension would allow money built up in a LiSA to be rolled into a pension at age 65, and so to benefit from the taxation of pensions.

Is there merit in this very general and simplifying approach? Should the roll-over into pensions be permitted, or encouraged?

8. What will the level of take-up be on the LiSA?

We have suggested that the level of take-up of the LiSA will be high. But how high? What is the right basis of comparison for take-up of the LiSA?

9. Should the use of the Government match be restricted?

We envisage that the Government's match amount, plus all accrued interest, is available to the LiSA saver at or after age 65 without any restriction. It is not included in the calculation of means-tested benefit, and there are no other limitations on use. A saver could in theory spend it all.

Is this the right approach? Should there be a requirement that this money be used for certain purposes: for example, to buy other capital assets, for long term care, or to pass on to other family members?

10. What is the best approach to charges for the LiSA?

High charges can quickly erode the value of an interest-earning account. Yet financial institutions need to be appropriately incentivised if they are to market and deliver a given product suite across the whole population.

The Cash LiSA is currently envisaged as a very widespread, and low-, perhaps very low, cost savings account, with interest paid net of charges (see the Appendix). Many questions arise, however. What charges should we expect to see on this product? Would there be substantial costs (e.g. from technology) to implement it? How would these change with the introduction of fixed income or equity products? Should financial institutions compete openly to sell these products? Or would it be preferable to have a panel of institutions, and if so, how should these be selected?

In conclusion: we would very much appreciate your considered feedback to any and all these questions, and to others that may occur to you.

Appendix: LiSA – The Detail

This Appendix outlines some early thoughts as to how the LiSA might work in detail. It covers topics such as mechanism for withdrawal of funds; possible extension of the LiSA framework to include fixed income and even equity products; implementation; charges; and taxation.

Structure

The LiSA encourages people to save by giving them the strong incentive of a matched payment in cash every year. The Matching Rule is very simple: a saver's contributions are matched with Government cash, every year. Savers need only save up to the match amount per month – perhaps simply by direct debit from payroll – in order to take the full benefit of this payment every year. The power of compounding interest then builds the sums saved up over time. Moreover, unlike a pension – where the saver may be understandably nervous about locking away money for the long-term – there is no disincentive to putting cash into the LiSA, since the saver's money can always be withdrawn.

The legal structure of the LiSA itself is also a simple one. There is the Saver's Account, and there is a Match Account, in which the Government's match payments are deposited, together with any interest accruing on those payments. Thus the two sets of funds are legally segregated from the outset. The Match Account is, in effect, acting as an escrow account.

Withdrawal of Savings

We want the LiSA to offer the flexibility for people to withdraw funds as their needs demand at different stages of their life – for example to put down a deposit on a new home.

But we also want to provide an incentive for people to restore those savings when they are able to do so. One of the limitations of ISAs is that if funds are withdrawn, they cannot subsequently be replaced.

We propose that for every year the balance in the Saver's Account is below the balance in the Match Account, the Match Account is reduced by 10% until the two accounts are in balance. This provides a strong incentive to replace savings during the years after withdrawal. But it guards against a possible loophole that would allow people to build up a substantial Government match over the years by simply depositing money in the Saver's Account and then immediately withdrawing it, never to be replaced until just before retirement (When a sum could be borrowed for the sole purpose of triggering the release of the Government match account).

Withdrawing Funds from a LiSA: A Worked Example

To see how this works in detail, take the following, simplified, case. The numbers used here are purely illustrative. Again, for the sake of simplicity, it assumes that a £1:£1 match, following the BOGOF principle.

At age 33, Jane has taken out a LiSA at the full amount every year for 15 years. She now has £10,000 in her Match Account; and the same amount, £10,000, in her Saver's Account.

Jane now withdraws all £10,000 in her Saver's Account, as part of a deposit she is putting down on a house.

The effect of the withdrawal is this. The Match Account balance falls by 10% p.a. of the amount of the withdrawal, on a straight-line basis. In other words, nothing happens to Jane's own savings, but the match amount to which she is entitled at 65 falls over time.

So if Jane replaces the withdrawn savings in the same year, nothing at all happens. If she replaces them after a year, her Match Account falls by 10% of the amount withdrawn – i.e. it would fall to £9,000 in the first year, £8,000 in the second year, etc.

The Withdrawal Rule, then, is straightforward: savers who replace withdrawn amounts within a year keep their entitlement to all of the matched amount they have built up. After that, the matched amount falls by 10% of the amount withdrawn every year. Moreover, it seems this rule can be readily implemented even for accounts with multiple withdrawals and replacements, by using average balances for the year in question.

The LiSA as a Product Wrapper

So far we have been discussing the basic model, an all-cash matched account, which we can call the "Cash LiSA". Like an ISA, however, the LiSA is designed to be a wrapper, not a product. That is, the enabling legislation would set out a simple and broad legal framework, within which financial institutions would be free to offer a range of products, allowing competition and innovation to flourish. These institutions would be those taking deposits, such as building societies, banks, credit unions and friendly societies.

The Government match would be offered at normal Government-backed interest rates. But we might expect early competition from the banks etc. for Savers' Accounts, on the basis of charges and interest rates offered.

Fixed Income Products

In principle, however, the LiSA could also be wrapped around products using other asset types. This is important, because of the diversification and yield enhancement potentially available from other products. Due to the nature of compound interest, improving the yield on the Saver's Account by even 1% over a long period substantially enhances the size of the final lump sum received.

On the fixed income side, suitable wrapped products might include Gilts for security, bond funds for yield, and relevant collective investment schemes generally. When the Government's new "stakeholder" (i.e. low-cost, no advice) products are introduced, these could also be included within a LiSA.

Equity Products

Fixed income products generally have fairly predictable and secure growth characteristics, and this makes them highly suitable for the cash match structure used by the LiSA. However, it may well be that equity products, such as equity index tracker funds, could also be included. Of course, equity funds can go up as well as down, and this creates two problems:

- ❖ The first is the case when, due to falls in the equity market, the Saver's Account has fallen to below the level of the Match Account. Should this be treated as analogous to a withdrawal from the Match Account?

- ❖ The second is the converse case, where the Saver's Account has made substantial gains. Should these gains be eligible for the Government match in each year?

The answers are, we suggest, No and No. Recall that both the Matching and Withdrawal rules operate not on balances within the Saver's Account, but on cash flows in and out of it. In the first case above, no withdrawal has taken place, and so the Match Account should not be reduced as per the Withdrawal Rule. In the second case, no new funds have been placed in the Saver's Account, and therefore increases due to equity performance should not be credited with the cash match.

Implementation

Any new savings wrapper, even one as simple and general as the LiSA, has the potential to introduce additional complexity into the marketplace. Implementation therefore needs to be as straightforward as possible.

The approach proposed here is this: that the saver simply designates an (existing or new) account at a savings (i.e. deposit-taking) institution as his or her LiSA Saver's Account. The savings institution – including perhaps National Savings and Investment, given its expertise in taking small deposits – would then apply to the Government to open a Match Account.

There are then several possibilities: according to the simple approach described above, at the end of each year the institution would apply to the Government for the cash match on the new amount saved during the year. Alternatively, a match sum might be paid in from the outset as an incentive, and a compensating amount returned by the savings institution at the end of the year if needed, depending on take-up. In either case, assuming full take-up of each account, at the end of every year the savings institution would have a meaningful sum in total deposits to carry forward.

Charges

The topic of charging arrangements for the LiSA is an important topic for consultation. However, some initial thoughts here are these:

- The Cash LiSA account will be a savings account at a deposit-taking institution. For reasons described below, the Cash LiSA is likely to be extremely popular, and many savers will build up funds quite quickly across both accounts. It is likely, then, that charges on the Cash LiSA will be low, perhaps very low.

- The use of the cash match is likely to improve the normally unattractive economics for financial institutions of servicing many small accounts. In particular, there will be almost no activity on, and so little or no cost from, the Match Account.

- It might perhaps be attractive for any charges to be included in the interest received in the Cash LiSA, rather than deducted from the capital sum. This would allow the saver to compare rates between providers on a more transparent basis; and might allay the fear that cash match was being lost because of deductions of charges from the Saver's Account.

- In practice, the present market minimum for investment in equity products is typically £500 p.a. Thus a fully subscribed LiSA, including the Government match, would need to be at or near this amount in order to qualify for investment in many existing equity products as they are, without the need for special charging arrangements.

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