ENCOURAGING SAVINGS THROUGH THE LIFE CYCLE

ABSTRACT

This paper discusses management of an individual's savings over the lifecycle. It introduces the concept of a 'Lifetime Savings Account', to provide a coherent framework for organising investments. A 'one-stop shop' for all financial needs, encompassing cash, medium- and long-term investments, managing credit card debt, accessing loans, life insurance and keeping an individual's pension entitlements in one place. The paper proposes replacing tax relief with matching saving incentives, which could be administered by the account, and recommends introduction of a fixed term ISA with incentives to keep invested for 5 years and extra incentive to renew or transfer to a pension. Finally, the paper introduces the concept of a 'Minimum Lifetime Annuity' which would be sufficient to ensure no need for means tested benefits, also suggesting it might be sufficient if an individual has adequate capital in the Lifetime Savings Account to be able to purchase such an annuity if necessary, without having to actually effect the transaction.

Key words: Savings, Pension, Annuity, tax relief, savings incentives, investment

INTRODUCTION:

As the UK population ages and increasing numbers of people are living longer, the cost of supporting older members of society is rising. The burden of providing for those who are retired has increased significantly in recent decades, compounded by trends to earlier retirement and longer periods in education, meaning later entry into the labour force and less time spent economically active, earning or saving.

If society wishes to avoid a substantial rise in the number of older people living in poverty, policy aims must focus on a number of issues:

1. ensuring individuals save more while they are economically active, in order to have more income to live on in later life
2. encouraging employers to provide higher contributions to occupational pensions
3. spending more public money on pensions and pensioners, to ensure income levels for the elderly are adequate
4. encouraging individuals to remain in the labour force for longer.

This paper focuses on the first of these policy options – increasing the levels of saving over an individual's lifetime, encouraging more saving from earlier stages in the lifecycle and helping people to build up a stock of assets to draw on in later life.

The UK has a higher level of retirement savings per individual than most of the rest of Europe and has built up a successful pension savings culture. This may be because of the low level of the UK state pension, which means people have had to provide more for themselves. In 1999, of the £4.6 trillion in funds under management, around five-sixths was by pensioners or for pensions[1]. Much of these pension savings are in defined benefit (DB) occupational pension schemes. However there are signs that the traditional occupational final salary pension scheme is becoming less prevalent and this trend brings with it a risk of much lower levels of pension for the UK workforce in the future. Many employers are switching to money purchase (DC) pension provision, and are taking the opportunity of this change to lower their contributions. In addition, there has been a general movement in social policy away from collectivism towards individualism. These trends imply a significant risk that savings will fall in the future. There are already many people who do not save much, if at all[2] and, if savings levels fall further, this will mean much higher costs of State support, much lower pensions and the risk of more poverty, particularly in later life as the population ages.

BARRIERS TO SAVING

Given the many benefits – both to the individual and to society as a whole that savings can bring – there must be powerful reasons why people do not save enough. Many people feel that the risks and difficulties of saving outweigh the risks and difficulties of <u>not</u> saving. Individuals often do not seem to understand how or why they should save and this is particularly the case for the less well-off members of society. Nearly half of low income groups and 70% of lone parents have no savings at all. Studies show that poverty itself does not explain these low saving levels[3], rather the explanation lies in the

[1] Wyman, Oliver, 2001
[2] Department for Work and Pensions, 2002
[3] HM Treasury, 2001

difficulties of the current system, inadequacies of government incentives and lack of financial education in society as a whole.

There are many reasons why people do not save. For the general population, factors such as finding savings boring and difficult, not being able to understand financial matters, not trusting financial institutions and not wanting to pay for advice, all prevent some people from saving. For lower income groups there are even more barriers. The social security benefits system militates against saving – means tested benefits penalise savings and tax relief gives more incentives to the highest earners, who would be most likely to save anyway. However, the Government really wants and needs to help more people to save, especially those who are not currently doing so.[4]

AIMS OF GOVERNMENT SAVINGS POLICY

UK Government policy aims to encourage saving and asset building by all members of society, not just at older ages and especially the lower earners.

Government recognises that individuals will benefit if they enter adulthood with some financial assets and have developed a savings habit.[4] The act of saving and accumulating assets has behavioural benefits for the individual (such as self reliance, ability to plan, financing their education) and also improves lifetime chances. In addition, society as a whole benefits from increased savings. Of course, in order to achieve the behavioural benefits, people have to actually save, just giving them cash handouts or loans will not achieve the aim. The Government is also committed to improving financial education and has charged the financial services regulator (the FSA) with this task. In terms of pensions, it has stated that it wants to move from a position where 60% of retirement income comes from the State to one where the State provides only 40%, with 60% from private sources.

Unfortunately, the current savings incentive and tax/benefits regime is highly unlikely to achieve the stated aims, despite numerous policy initiatives being introduced since 1997. Government has introduced a range of policies which are generally designed to increase private savings, especially by low income groups. These include the following measures:

- introduction of tax favoured savings, up to an annual limit, in the form of Individual Savings Accounts (ISA's)
- introduction of stakeholder pensions – a simple low cost pension with limits on charges, and other terms. Employers with over 5 employees are required to provide access to these pension products, if the company has no occupational scheme
- introduction of the Pension Credit, which is designed to ensure that those who are retired and drawing means tested benefits do not lose all their retirement savings, by allowing them to keep 60% of any private savings they have
- increase in the amount of capital one can hold before reducing entitlement to means tested benefits
- initiatives to ensure fairer terms and charging structures for financial products (CAT standards)
- creating one unified regulator to oversee the industry (the FSA)

[4] HM Treasury, 2001

- introduction of basic financial education into the secondary school curriculum in England.

These are all measures designed to increase consumer confidence in the financial services sector, to encourage and facilitate more savings. However, they are not having the desired effect. For example, the Pension Credit is likely to prevent stakeholder pensions being taken up by their target market and, indeed, is a major disincentive to savings by lower earners. The interaction between the benefits system and savings incentives is a particular problem for policy.

However, there are two new proposals which have the potential, if structured correctly, to make a meaningful difference to the savings environment in future generations. The first is the Child Trust Fund (or Baby Bond as it is sometimes called). This could be an effective way to kick start the savings habit for children and it could be built upon to encourage them to keep saving throughout their lifetime. It would need to incorporate good financial education and it would be important to keep the account open at age 18 too, rather than closing it and spending all the accumulated funds. Secondly, the Savings Gateway proposal, which is being piloted at the moment, offers matching payments from Government for very low income groups who manage to save. This is intended to demonstrate to them, first hand, the power of saving and encourage them to develop a saving habit.

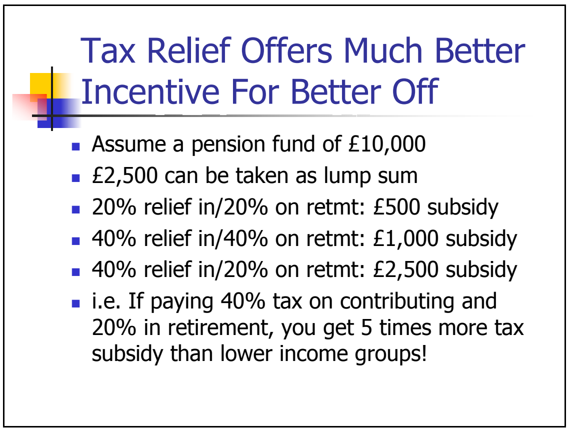
CURRENT UK SAVINGS INCENTIVE SYSTEM

At the moment, the system of incentives to save in the UK revolves around tax relief. There is generous tax relief for pension contributions, especially for high earners, and there is a large range of tax free or tax favoured products. In fact, most people could do all their savings tax free – but many do not seem to realise this. Of course, tax relief is not actually much of an incentive, if any, for lower income groups.[5] It very much favours the high paid.[6] Figures 1 and 2 demonstrate this with some examples of the effect of tax relief on pension contributions and pensions (for ease of presentation, basic rate tax is assumed to be 20%, rather than 22%).

The tax free lump sum in the pension is a very valuable benefit to a higher rate tax payer. For those individuals on 40% tax both when contributing and in retirement, the value of the effective subsidy offered by the lump sum is twice as large as the subsidy for those paying lower rate tax when contributing and in retirement. For example with a £10,000 pension pot, the subsidy for a lower rate tax payer amounts to around £500, compared with £1,000 for the higher rate payer. However, the largest benefits accrue to those who were higher rate taxpayers when contributing and become lower rate taxpayers in retirement. They receive 5 times the amount for the lower income group.

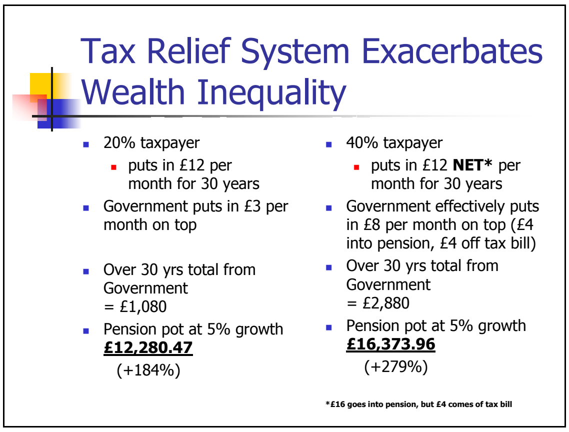
[5] Altmann, R. in IPPR, 2003
[6] Agulnick, P. and Legrand J., 1998

FIGURE 1



This also applies to the tax relief on pension contributions themselves. Over recent years, the inequality of wealth in the UK has increased. Figure 2 shows that the effect of higher rate tax relief, versus standard rate tax can exacerbate wealth inequalities. The present system of tax relief means that, for every £3 that top earners contribute to their pension, Government adds £2, whereas for every £3 basic rate taxpayers contribute to their pension, Government adds just 85p. There is obviously far more incentive for the top 10% of taxpayers (who are those on higher rate tax).[7] The impact of compounding over time of the extra amounts put into the pension from government tax relief mean that, for the same <u>effective</u> cost, and same investment growth, the highest income groups would end up with much larger pension funds from the same level of contributions.

FIGURE 2



In order to encourage more middle income groups to save, a new approach is needed.

NEW SAVINGS INCENTIVE SYSTEM

The current system based on tax relief is regressive and gives the largest encouragement to the top earners, who would probably save anyway. The relief also

[7] Altmann, R. Parry, D., Aberdeen Asset Management, 2003

fails to differentiate between different types of savings product. Pensions are no more favourably treated than cash ISA's. This paper discusses a recommendation to consider replacing tax relief with a new fairer system of 'government saving incentives' which will give the same financial incentive to everyone, for the same amount of savings.[8] Non-taxpayers would also be able to benefit from the same 'matching payments' as the highest income groups. In fact, stakeholder pensions have already set a precedent for this, where non-taxpayers still receive basic rate 'tax relief' or grossing up by 22%.

Middle income groups would surely be much more likely to save if they received the same amount of incentive as current top earners do. In other words, giving everyone the equivalent of higher rate tax relief (£2 for every £3 contributed, up to a certain limit).[9] This system would immediately offer a much more powerful incentive to lower rate taxpayers to start saving and perhaps to put money into a pension. If combined with an approach which encouraged saving from earlier in life, even if these savings were not in the form of pensions, more individuals would be likely to provide for their own future needs.

ESTABLISHING A LIFETIME SAVINGS CULTURE

In order to get more people saving, for more years, it is necessary to change social attitudes and establish a lifetime savings culture. Individuals should be encouraged to save in other forms, not necessarily just pensions. Some will not want to, or be able to risk locking their money away for many years and may be better advised to save in other vehicles. If individuals are scared to put their money into a 'locked box', they could be encouraged to save in medium term or shorter term vehicles first, with a lower level of matching incentive than for pensions, but then receive higher incentives if they transfer this money to pensions later. We need to make savings easier to understand, with fairer incentives and a more integrated coherent system. We also need to improve financial education, so that people can better understand why and how they should save.

The Lifetime Savings Framework can address these issues. What is required is not <u>just</u> new products, or <u>just</u> better incentives, but a new structure, which can help to integrate all the current savings and investment products – both tax favoured and other – into a coherent framework. It could provide a 'one-stop shop' to cater for all a person's financial needs, throughout their lifetime. Progressing from birth to death and from short term cash accounts to 'locked' pension investments.

THE LIFETIME SAVINGS ACCOUNT

The Lifetime Savings Account concept (which might be called a 'LifeSaver' for short) could be used to look after all of an individual's financial needs in one wrapper, including the government savings incentives.

So what might this Lifetime Savings Framework account look like? A Lifetime Savings Account would be likely to need a section for children, who then graduate on to the adult part, which would consist of a short term cash account section, medium term

[8] Agulnick, P. and Legrand, J., 1998
[9] Altmann, R., in IPPR, 2003

investments and a 'locked' retirement section, with Government matching incentives to move on from each part to the next.

In fact, the current financial marketplace already has the elements of all these sections, but the present system has not been portrayed in this way. In addition, there are many products which can be used to save tax free, but people are often not aware of them all, or how they fit together. All these products could be put into a new framework which, firstly tries to draw together what is available today and, secondly, incorporates new government financial incentives, into a system which encourages and helps people to save throughout their lifetime. It recognises that there will be times when people need to borrow, rather than save, but this can be incorporated into the framework too. The following sections explain how this Lifetime Saving Account could be constructed and Figure 7 shows the full picture. The account would comprise a different sections, linked together by incentives. There would be a Children's Section, then short-term, medium-term and long-term (retirement) saving elements.

All products that enable individuals to save tax free at the moment are identified to the left of the dotted line shown in Figures 3 - 7. There are many products which can bought tax-free or with favourable tax treatment. By listing them all together in this coherent framework, people should be better able to realise the tax free opportunities that are available to them and take better advantage of them.

IMPLEMENTATION OF LIFETIME SAVINGS ACCOUNTS

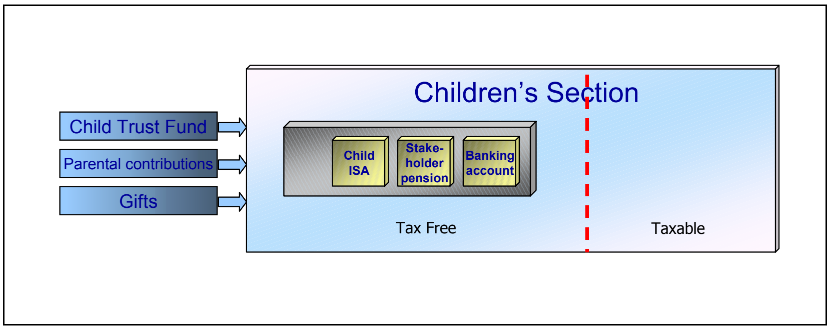
The account would be able to hold the products of many different providers, should be subject to CAT standards for charges and could transfer from one provider to another. The major function of the account provider would be administrative and to offer education or advice, rather than investment management itself. Each individual could only have one of these accounts at any time, so that Government savings incentives and annual limits can be accommodated properly. Loans could be taken out against the fund, if needed from time to time, for example for education, housing and for emergencies. Insurance could be offered with the account (life cover, health and other types) and credit card debt could be managed from it. All money purchase (DC) pension entitlements could be kept in one place and the fund would be useful to help provide additional income for individuals in later life, as the UK moves to a system of more gradual retirement. One of the easiest ways to solve the problems of supporting an ageing society is to encourage people to work and keep earning for longer. Retirement and pension policy has lagged significantly behind the changes in demography and health status which have occurred in the last half century or so. Retirement should be thought of as a process, rather than an event and there should be opportunities to gradually cut down, rather than suddenly stop working. Then people could take a partial pension and keep earning to better support themselves in later life.

Education would be a fundamental part of this account, as indicated in Figure 7. The provider of the Lifetime Savings Framework account could incorporate financial education, helplines, on-line tutorials and possibly even advice, to try to ensure that individuals are helped to plan their finances through their lifetime.

Figure 3 shows how the Lifetime Savings Account could start, focussing on the Children's Section first. Figures 4, 5 and 6 introduce the other parts of the Framework and then Figure 7 shows the whole picture.

CHILDREN'S SECTION

FIGURE 3



The younger one is encouraged to start saving the better, which is why the idea of the Baby Bond could be so effective. Starting at birth, the Child Trust Fund could be paid into a Children's Section of the account. It might be helpful if this were to be called a 'Child ISA', in order to integrate it better with existing policies. In fact, it may be advisable to build all the products for incentivising savings around the ISA name. Why introduce yet another three letter acronym or product name, people are confused enough as it is?

This Child ISA would be paid to every baby in the country and could therefore be used to seed a Lifetime Savings Account for every child. Each individual in the country should be encouraged to have one of these accounts, and it would need to be combined with a 'unique identifier' (such as National Insurance number, if possible) to avoid duplication of entitlements.

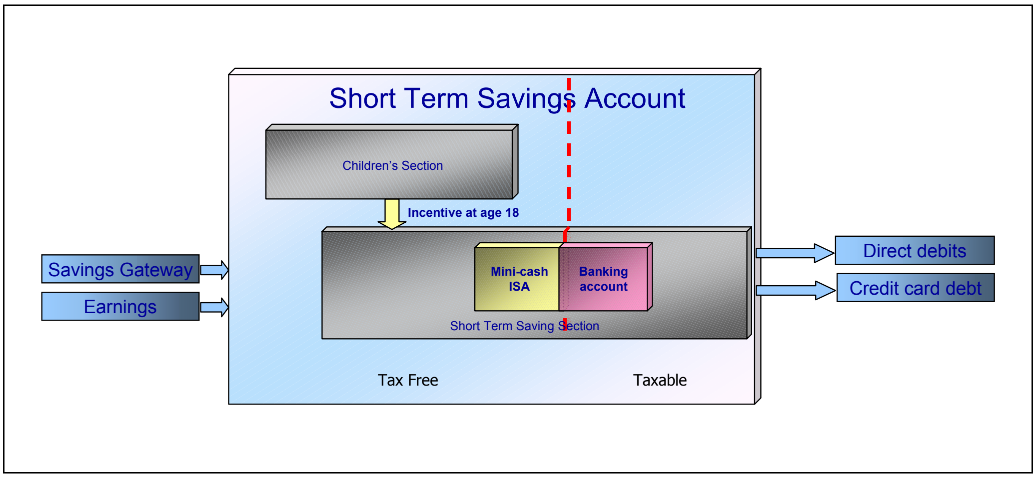
Apart from this Child ISA, parents or other relatives could contribute additional amounts and, even now, children can own stakeholder pensions. If they have earnings, or receive birthday presents, these can be paid into the Child Section of the Lifetime Savings Account and would normally grow tax free. The current government proposal for the Baby Bond is that, at age 18, the child will be free to spend the funds as they wish. However, this would be a dreadful waste! It would be useful to encourage individuals to transfer to the Adult Section at age 18.

SHORT-TERM SAVINGS SECTION

Figure 4 shows that it is proposed to offer individuals an incentive at age 18 to keep their account open and ensure that they have at least a short term savings account in which to put any savings they may wish to make. Currently, a significant minority of the population has no bank account. This militates against saving.

It is important that individuals should have a vehicle in which they can save. Studies show that, even if people have money to save, they often cannot be bothered to open an account, so they just spend it. But, if every young adult already has an account they are familiar with, which they have followed for many years, they will know what to do. For example, when they earn their first pay cheques, these can be paid into the cash section of the account or could be put into a longer term holding. If the account is closed at age 18, some of the major benefits of the Baby Bond policy for developing lifetime savings habits would be lost. The new Savings Gateway proposal for the poorest members of society could also be incorporated into the cash section of a Lifetime Savings Account, as shown in Figure 4.

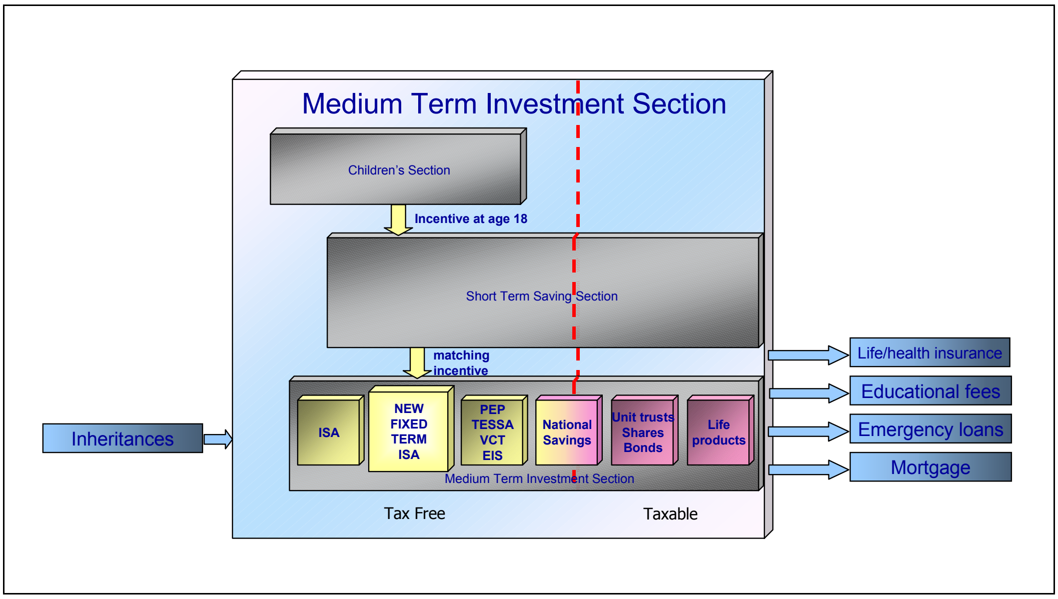
FIGURE 4



MEDIUM TERM INVESTMENT SECTION

The majority of financial investment products available today would be included in the 'Medium Term Investments' Section of the account, as shown in Figure 5.

FIGURE 5



Most financial investment products would be considered medium term investments. On the tax free or tax favoured side, there are ISA products, which are completely withdrawable and then PEP's, VCT's, EIS's and also some of the National Savings bonds. Then there are other products with little or no tax advantages – shown to the right of the dotted line.

The one vehicle not available at the moment is a medium term ISA-style investment product, which can invest in equities and bonds, but must be held for, say, 5 years. ISA's are currently withdrawable immediately. Government should consider introducing a fixed term ISA, which could form part of the medium term section of the Lifetime Savings Account. It could have a standard level of matching financial incentive, which would apply to everyone, regardless of their tax code, but at a less generous level than for pensions. For example, for every £3 put in, Government will put in 85p (as with the current basic rate tax relief). The amount that could be put into this each year would be limited by the Government and it would also be helpful to offer additional incentives for people to keep their money in the product for longer, on maturity. For example an extra 5% added every 5 or 10 years. This could be designed to help people to realise they can manage without the funds in this medium term ISA and then to keep saving, rather than spending it. It should be taxed on withdrawal, to further discourage spending the money, unless absolutely necessary. Figure 5 shows how this new product would fit in.

BORROWING AS WELL AS SAVING

Figure 5 also shows a Lifetime Savings Account could be used for direct debits, as a normal bank account and to help people better manage credit card debt – making it easier to pay off balances and help keep interest costs minimised. Life, health and other insurances could be built in and, of course, there would be borrowing facilities, using any assets in the account and earnings records as security for loans, perhaps for education – even mid career retraining – and emergency loans if needed.

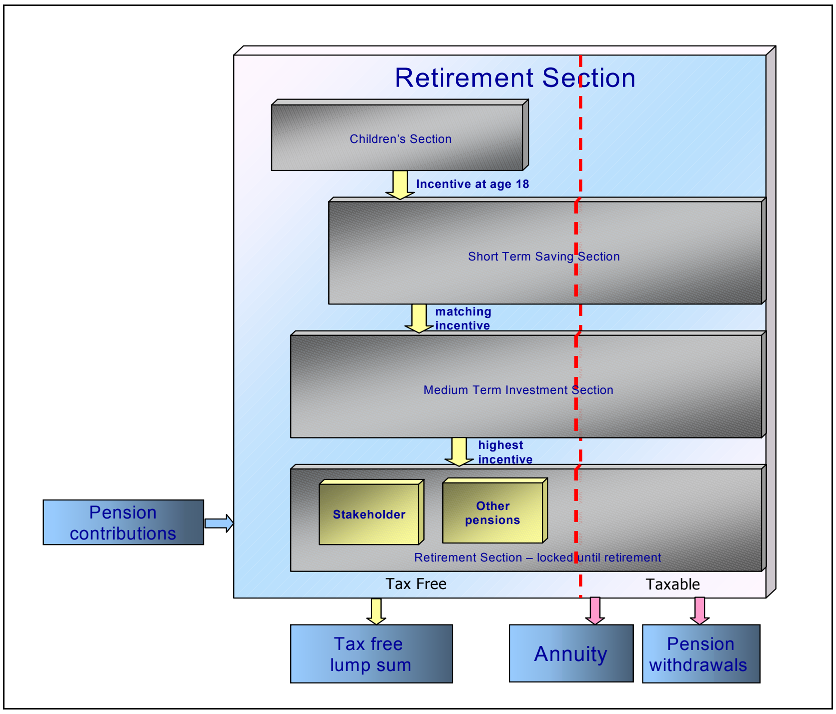
The Lifetime Savings Account could even be used for mortgage lending, to finance the other major asset, apart from a pension fund, which people accumulate over their lifetime – that is their house. This is also tax free if owner occupied.

The aim would be to encourage individuals to move from the medium term section to the retirement section, which would be locked until later life, but would benefit from the highest levels of government financial incentive in exchange for the lock in.

LONG TERM INVESTMENTS (RETIREMENT) SECTION

Figure 6 shows the long term investment section, which would be products locked until retirement. It is recommended that investments in this section should have the highest level of matching incentive to encourage people to lock their money away for long periods of time. For example, the retirement section could be incentivised by adding £2 for every £3 contributed, as with higher rate tax relief now. This highest government financial incentive should be the same for everyone, regardless of their income or their age. At the moment, those who earn most are allowed to put more into their pension than those who are young or earning less.

FIGURE 6



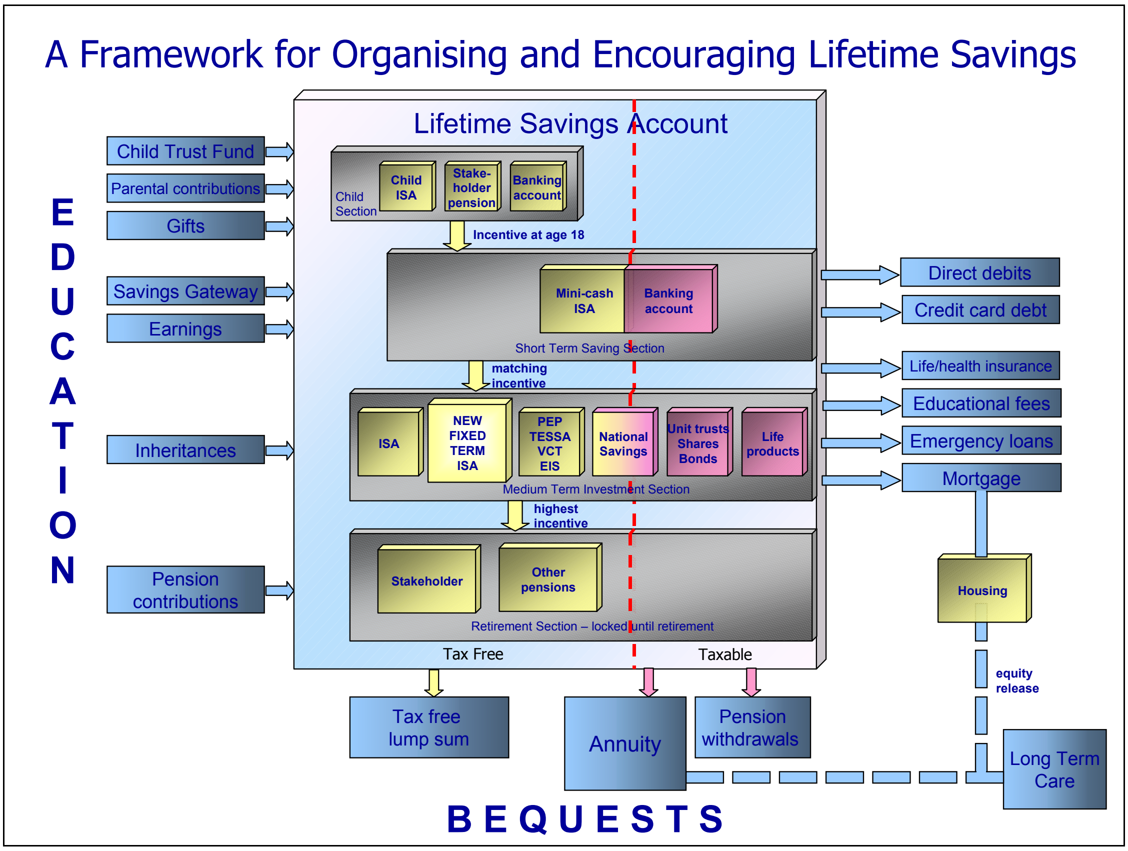
A significant advantage of having such a 'retirement section' would be that all people's money purchase (DC) pensions would be held in one place, with pension entitlements from previous employers and any stakeholder or personal pensions being put into the retirement section of the Lifetime Savings Account. People could then see more easily what pension funds they have, ascertain what level of pension this could produce and then decide if they need to put in more to achieve their desired standard of living.

Government's current proposals for combined benefit statements will not address this issue, since each pool of pensions savings will send a separate statement and *each* will include an estimate of State pension. This will lead to double counting and confusion, whereas, if pension entitlements were all held in one place, they could be tracked properly and combined statements would be more meaningful. Having all DC entitlements in one place should also be useful for annuitising at the point of full or partial retirement, since there will be fewer delays in tracking past entitlements.

THE WHOLE LIFE CYCLE

Figure 7 shows the complete picture for the rest of the life cycle. The Lifetime Savings account would be used to provide income which individuals can live on in later life. The retirement section would encompass pension savings, which can partly be taken tax free and the remainder of the funds would be used to provide the pension.

FIGURE 7



MINIMUM LIFETIME ANNUITY

In years to come, it may be that people will be able to choose only to annuitise up to a particular lifetime income level, which would ensure that they need not rely on State support at all (although such a change has been ruled out for the moment). Current UK policy requires the entire value of an individual's pension fund to be used to purchase an income by age 75. Government is adamant that this income requirement will not be changed. However, there remains a likelihood that some changes will be made in the medium term. This paper suggests it would be reasonable to replace the 'age 75 annuity rule' with a concept of a 'minimum lifetime annuity'. This would entail the securing of an income level that would ensure no eligibility for means tested benefits, for example buying an annuity up to a level, say, 50% above the 'poverty line'. In fact, it could be argued that, as long as government savings incentives ensure that everyone has at least this level of income throughout their lives, no further savings incentives are needed. All government incentives could ultimately be targeted to provide a sum that would ensure everyone can look after themselves without State support. The rest, subject to being taxed, could be spent or saved as desired.

It would be helpful to provide some actuarial estimates of a set of annual savings amounts which would be sufficient, given appropriate investment assumptions, to ensure that this minimum lifetime annuity could be funded. The annual limits for saving in ISA's and pensions could then perhaps be set with reference to this amount, which would also have the advantage of providing a rationale for the limits chosen.

As DC pension provision grows and matures and as the population ages, there may come a point where the supply of gilts and bonds to back all the annuities demanded by maturing pensions will be insufficient. In this scenario, the Minimum Lifetime Annuity concept could be useful, to prevent too great a demand on the annuity market.

In fact, it may even be that policy need not force people to actually buy an annuity, just as long as they have enough funds to be able to do so, if they do need to. This sum could also come from equity release, rather than the pension fund. People would then be free to do whatever they want with the rest of the pension monies, but it would need to be taxed on withdrawal and it must be taxed on death, separately from the person's estate, so as not to escape inheritance tax. Equity release would also be a useful method of providing for the expense of long-term care in the latter stages of an individual's life, if it is required, since pension income is unlikely to be sufficient for this.

CONCLUSION AND IMPLICATIONS

In conclusion, there are serious risks that overall levels of pensions and savings will fall in coming years, if government policy remains unchanged. This paper suggests that a new fairer system of government incentives is required, to encourage more saving by 'middle Britain'.

One way to achieve this may be to develop a coherent framework for managing financial needs throughout a person's lifetime, to encourage them to save from an early age and keep saving regularly throughout their lives.

Implementation of such a system could be organised to ensure that every individual had access to one 'Lifetime Savings Account', which would be identified by a unique reference such as a National Insurance Number. The accounts could be held by any approved financial provider and would be permitted to hold products from a wide range of financial companies – banks, insurers, fund managers, brokers. The ideal would be for Government financial incentives to work coherently through the savings product range, with the highest incentive for the pension products, lower incentives for medium term products and least incentives (if any) for short term savings. The Account would provide a 'wrapper' to administer all a person's savings, investment and borrowing needs through the life cycle and should include access to advice and education as part of the package. If these accounts could be run in groups – such as via unions, workplace and so on, then economies of scale could be reaped to provide lower charges. Charging structures would be important and ensuring that people only received incentives on one of these accounts per person would be important too. This is similar to requiring limits on pension and ISA contributions, so the issue of security should be manageable.

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