Which?, 2 Marylebone Road, London, NW1 4DF
Date: 20 January 2017
Response to: Financial Conduct Authority consultation on *Handbook Changes to Reflect the Introduction of the Lifetime ISA*

Consultation Response

Donald Cranswick and Emily Pinkerton
Pension and Insurance Policy Department
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

About Which?

Which? is the largest consumer organisation in the UK with more than 1.5 million members and supporters. We operate as an independent, a-political, social enterprise working for all consumers and funded solely by our commercial ventures. We receive no government money, public donations, or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

Summary

We welcome the opportunity to respond to the Financial Conduct Authority's (FCA) consultation on its proposed handbook changes to reflect the introduction of the Lifetime ISA (LISA). The FCA notes that there are specific features of the LISA, notably the 25% early withdrawal charge and its combined function as either a short to medium term savings product to provide a deposit for a first home or as a long term investment product for retirement, which present significant risks to consumers.

There is a clear risk that consumers may not understand the purpose, features and restrictions of the LISA. There is also a danger that it undermines auto-enrolment and saving for retirement through a workplace pension, which for many consumers will be a more suitable vehicle for long-term savings. As such, it is critical that the FCA introduces robust regulation to protect consumers from the risks it has rightly identified, and Which? broadly supports the proposed handbook changes.

Consumers are not yet able to open a LISA, so there is no evidence of actual consumer behaviour and outcomes. The FCA must undertake early research from April 2017 to swiftly identify any poor outcomes and understand consumer behaviour in the market.

The early withdrawal charge

The LISA is a specific product suitable for people in particular circumstances, and it comes with tough penalties if it is used for any purpose other than as a deposit for a first time home, or as retirement savings to be accessed after the age of 60.

The investment strategies for saving for a deposit for a first home and saving for retirement are likely to be very different. For example, if a consumer saved into a LISA intending to use it to save for a deposit to buy a home, but then due to changes in personal circumstances (for example, entering a relationship with someone who already owns a home and moving in together) decided to use it to provide retirement savings, the LISA might not be the right savings vehicle for this new goal, with the investor unable to access their funds without penalty until age 60.

In particular, investors may not fully understand the impact of the early withdrawal charge and any additional charges that providers may levy. The LISA imposes a 25% early withdrawal charge on any withdrawals outside of someone buying their first home, reaching the age of 60, or suffering from a terminal illness. The FCA states that rational investors would invest in a LISA only in the presence of a reasonable expectation of not needing the funds before age 60 or of buying a first home. However, there is a risk that some consumers will withdraw money before age 60 without buying a home, hence paying the early withdrawal charge.

Consumers may wrongly believe that the 25% early withdrawal charge would be roughly equivalent to giving up only the 25% government bonus. However, the FCA states that this early withdrawal charge is "equivalent to losing the whole of the Government bonus, the returns on that bonus, and paying a further 6.25% charge on one's contributions and the returns on those contributions of withdrawal."

Sellers must be responsible for communicating the features and particularly when the withdrawal charge applies - for example, if the investor accesses the LISA for other expenditure, including unexpected emergencies, before they are 60 (unless they are terminally ill). Sellers must also make it clear to consumers that the LISA cannot be used – or if it is, the withdrawal charge will apply – in the following circumstances: if the LISA is used for a buy-to-let mortgage; if the investor owns, purchases or comes to own property without using the LISA and then uses it to buy a property; or if the LISA is used to buy a joint mortgage with someone who already owns property. Sellers must also communicate the other circumstances in which the early withdrawal charge can apply if the investor buys or subsequently uses a property in a certain way.

Sellers must also highlight to investors that the charge will remove more than just the government bonus, and that therefore investors should be cautious when considering the LISA as a savings product.

Mitigating against the risk of undermining auto-enrolment

The FCA must ensure that there is total clarity about the merits of auto-enrolment over the LISA - and that, because of the cut-off age for LISA contributions, it is not suitable to be someone's total private pension. There is a significant risk that consumers opting to save into a LISA may reduce savings in pension products below the level in line with their long-term needs.

The FCA recognises the risk that consumers may not sufficiently understand the differences between the features of a LISA and other forms of retirement saving, notably pensions, in order to make informed decisions about the benefits and risks of each for their own circumstances.

If consumers opt out of auto-enrolment workplace pension schemes in favour of saving in an LISA, they will lose out on the employer's pension contribution. Consumers might not be aware of employers' contributions in auto-enrolment, or they may overvalue the government bonus provided within the LISA and the flexibility of a LISA when compared with a pension. The FCA is right to recognise that sellers of the LISA would have a clear incentive to frame their offerings to reinforce the benefit of the bonus, over other features such as the early withdrawal charge.

There is also a likely risk that consumers will not be fully aware of the tax relief associated with pension saving. For higher-rate earners, the value of tax relief provided by a pension exceeds the value of the bonus in a LISA.

The FCA believes that its proposals, based on warnings and information disclosures, will remind consumers looking to save into a LISA not to overlook the potential loss of employers' contributions from opting-out of auto-enrolment. The FCA should require clear disclosure on the merits of auto-enrolment, including the tax relief associated with pension saving, in all sellers' communications.

Measurement and evaluation

The FCA cannot yet observe evidence of actual behaviour and outcomes for consumers investing into LISAs, as the market will not exist until April 2017. However, the FCA should set out how it will measure and evaluate the impact of its rules, to identify poor outcomes, including the impact on auto-enrolment, from the moment the market begins.

The FCA states that rational investors would invest in a LISA only in the presence of a reasonable expectation of not needing the funds before age 60 or of buying a first home. There is a clear risk that some investors will withdraw money before age 60 without buying a home, hence paying the early withdrawal charge. The FCA should require firms to report on the number of consumers paying the early withdrawal charge, however waiting to see the number of withdrawal charges – which may only become apparent in many years' time – will be too late. It will also fail to indicate the number of consumers who should not have taken out the product but kept it to avoid the charge. As such, the FCA should conduct early research with LISA owners to understand why they took the product out and whether they understand it.

The evaluation should also cover the effectiveness of the communications and warnings that the FCA requires sellers to provide. The FCA's research with LISA owners should investigate the extent to which any LISA owners have not made withdrawals, to avoid the 25% withdrawal charge, but where this was also a sub-optimal choice – e.g. turning to high cost forms of credit as an alternative or keeping their money in an savings vehicle that was no longer right for their needs.

Richard Piggin, Campaign Manager, Which?, 2 Marylebone Road, London NW1 4DF
richard.piggin@which.co.uk 020 7770 7545