Centre for Policy Studies

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INTRODUCING EDUCATION SAVINGS PLANS

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SUMMARY

- As a result of the 2012 changes in higher education funding, student debt is at an all-time high.
- Student loans are now charged at a real rate of interest from the first year of university. Loans to cover maintenance costs worsen the considerable financial burdens imposed on graduates.
- Many young people have financial difficulties. The debt charity StepChange reports an 85% increase in 18-24 year-olds seeking help from 2010-2013. The UK Financial Capability Strategy identifies Young People, up to the age of 24 as a key priority.
- This paper proposes that higher education should be funded with assets, not debt.
- This will be achieved with the introduction of Education Savings Plans – a means for prospective students to save for higher education expenses and living costs.
- The policy would relieve students of debt and promote more positive attitudes and motivation to manage money successfully.
- Education Savings Plans would use existing Junior NISAs legislation and build on the existing brand recognition of ISAs.
- Education Savings Plans would offer financial products suitable from birth until higher education, when withdrawals will commence.
- A Scholarship and Bursary fund for those unable to contribute to a plan would also be created, whereby providers of Education Savings Plans would contribute a portion of their fees into a pooled charitable trust.
- Based on preliminary figures, for each family that used their full Junior NISA allowance for their child's Education Savings Plan, a £2,000 bursary would be created for a financially less advantaged child, at no cost to the taxpayer.

FIVE PROPOSALS

Proposal 1: Education Savings Plans should be introduced to ensure that young people and their supporters are not deterred by concerns over student debt and tuition fees from aspiring to higher education.

Proposal 2: Education Savings Plans can operate using existing Junior NISAs legislation, building on the existing brand recognition of ISAs. Plans would offer financial products suitable for the time horizon from point of investment (e.g. at birth, but at any stage up to 18), until higher education – and withdrawals – commence. At 18 the ESP Junior ISA would either be used to fund higher education or would become a NISA, as with existing Junior ISA legislation.

Proposal 3: Introduce a Government kitemark scheme and product badge awarded to Education Savings Plans that meet certain stakeholder-style criteria on charges, access and terms. This would build on the popularity of Child Trust Funds. The product badge would help potential savers to identify the clear purpose for their account and could draw on policy and guidance from other savings programmes and agendas such as Child Trust Funds, Automatic Enrolment and Simplified Financial Products.

Proposal 4: Simplify investment decisions by offering a personalised default investment option based on the beneficiary's age. Like stakeholder Child Trust Funds, Education Savings Plans would by default manage the level of risk of the investments with respect to the time horizon remaining. This would be convenient for savers who lack the confidence to construct, manage and monitor their own portfolio. This would also help resolve the issue of stakeholder Child Trust Funds being migrated to Junior ISAs from April 2015 where no such protection (on cost or investment risk) is in place. This would also ensure that ESPs are easily accessible to all without the need for financial advice in the context of FCA's guidance consultation.[1]

Proposal 5: A Scholarship and Bursary fund for the financially disadvantaged should be created by providers of Education Savings Plans. This fund would contribute a portion of providers' fees into a pooled charitable trust to be used by universities and colleges to offer scholarships and bursaries to students from disadvantaged backgrounds. Partnerships can be created between ESP providers and schools and universities, and additionally with charities that promote financial inclusions, financial education and access to education.

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1 Financial Conduct Authority *"GC 14-03 Retail investment advice: clarifying the boundaries and exploring the barriers to market development"* 2014.

1. INTRODUCTION

The 2012 reforms to higher education funding, in which the cap on university tuition fees was raised, have resulted in record levels of student debt. Students are now charged real interest rates on income-contingent loans whilst they are studying – with loans being repaid once graduates are earning over a certain income threshold.

Many young people are in financial difficulties. According to the debt charity StepChange, between 2010 and 2013 there was an 85% increase in 18-24 year-olds seeking their help.[2] The UK Financial Capability Strategy identifies Young People, up to the age of 24 as a key priority.[3]

The introduction of a real (above-inflation) interest rate of up to 3% means that 45% of graduates will repay more than they borrowed in real terms under the new system. However, the Institute of Fiscal Studies (IFS) estimates that 73% will have some debt written off at the end of the repayment period.[4]

The new system is progressive: the lowest-earning graduates will be better off as a result of the higher repayment threshold. However the increase in university tuition fees could have an impact on deterring applications to university and college – especially those from students from disadvantaged backgrounds.

The gap in participation rates between the most and least disadvantaged remains very wide.[5] 18-year-olds from the most advantaged areas are still three times more likely to apply to higher education than those from the most disadvantaged areas, and entry rates to institutions that require high grades are typically six to nine times greater for applicants from advantaged areas.[6]

Whilst there is not yet substantial evidence that the increase in tuition fees is a deterrent to new university applicants, the total number of applicants in 2013-14 is 5.4% lower than in 2010-11, the year before the new system was announced.[7]

1.1 Participation in higher education

To ensure that the introduction of higher tuition fees does not impact the Government's aims of widening participation, universities and colleges that choose to charge higher fees are required to have an access agreement approved by the Director of Fair Access[8] that sets out their outreach programmes and financial support arrangements. These agreements typically also include admissions arrangements that promote positive discrimination towards students from disadvantaged backgrounds.[9] Participation figures do not yet show significant falls in university and college applications from disadvantaged students, but it is not clear how much this can attributed to the success of outreach programmes and financial support arrangements, or is the result of student selection practices.

2 Financial Capability Strategy UK *"Children and Young People"* 2014.

3 Financial Capability Strategy UK *"The draft strategy."* 2014.

4 Institute for Fiscal Studies *"IFS Report R93"* 2014.

5 Higher Education Funding Council for England *"Higher Education in England: Impact of the 2012 reforms."* 2013.

6 Higher Education Funding Council for England *"A briefing on: Impact of the 2012 reforms"* 2014.

7 Higher Education Funding Council for England *"Higher Education in England: Impact of the 2012 reforms."* 2013.

8 Office for Fair Access *"Find an access agreement"* 2014.

9 Ibid.

1.2 Overdependence on debt

An additional risk is that high tuition fees financed by student loans sends out the wrong message to students and is likely to influence their behaviour in unintended ways. For example, burdening students with 'debt' at the earliest stage of their career – regardless of whether repayment is contingent on income – could have a negative impact on young people's long-term financial wellbeing.

Furthermore, encouraging students to accrue debt will necessarily affect attitudes and motivation on financial decisions in the future (e.g. managing credit and debt and identifying appropriate products and services). Positive savings behaviour sticks, as does non-saving: a report published by the Consumer Financial Education Body (CFEB) found that 65% of non-savers were still not saving 15 years later.[10] Becoming accustomed to accruing debt also impacts graduates' ability to plan ahead, to save and to make financially prudent decisions.

2. ASSETS, NOT DEBT

Educational Savings Plans could be used to fund education with student assets rather than student debt. Broad access to easy-to-use savings plans would enable a savings habit and better management of personal finances. It would create confident, capable savers by providing financial products that most people will understand, for a purpose most useful to them. Students who start university with their own assets are more likely to develop financial abilities through 'experience and reflection' than those who only accrue debt.[11] Furthermore, apart from the student loan system, many students also incur personal debt which they have to service immediately, regardless of their earnings.[12] Students who start higher education with their own assets are less likely to find themselves in difficult financial circumstances in the future.

Bursaries and scholarships could be made available for disadvantaged students so that they too could start higher education with their own assets, enabling them to enjoy the same benefits of lower student debt and gain experience of managing their own money.

2.1 The state of student indebtedness

Currently, students can expect to graduate with average debts in excess of £40,000 from tuition fees and maintenance. Students are charged a real interest rate of 3% on maintenance loans whilst they are studying and between 0% to 3% on graduation, depending on income.[13]

All students are entitled to income contingent loans for tuition fees, whereas maintenance loans are means-tested and maintenance grants are available only for those from low-income households. The maximum maintenance loan is £5,500 for students living away from home (and outside London). The loan is tapered away at 10% for household income (above £42,875) with all students guaranteed at least 65% of the maximum loan.[14]

3. EDUCATION SAVINGS PLANS

3.1 A kitemark for the Junior ISA

An Education Savings Plan (ESP) kitemark and badge for certain Junior ISA accounts would improve access to low cost saving for higher education.

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[10] Consumer Financial Education Body *"Financial capability and saving: Evidence from the BHPS"* 2010.

[11] Financial Capability Strategy UK *"The draft strategy."* 2014.

[12] Department of Enterprise, Trade and Investment *"Taking Control: A Financial Capability Strategy for NI"* 2013.

[13] Institute for Fiscal Studies *"IFS Report R93"* 2014.

[14] Ibid.

Like stakeholder Child Trust Funds (CTF), the investment risk of the assets should be reduced on approach to a child's 18th birthday when withdrawals are expected to commence, thereby offering savers the same protection that they value in these products.

Technological developments in the investment industry mean that it would be reasonable to have a fee cap of 1.00% per year (including fund costs (Ongoing Charges Figure) and administration costs). This is a 33% reduction in the fee cap of 1.50% per year for CTFs.

Furthermore, a portion of that 1.00% fee could be given by the provider into a pooled charitable trust from all ESP providers. This trust could then be used to make donations to higher education establishments for bursaries and scholarships for the financially disadvantaged, whose parents and supporters were not able to contribute into an ESP.

Preliminary estimates suggest that for each family wanting to subscribe in full to an ESP kitemarked Junior ISA, a £2,000 bursary would be created for a financially disadvantaged contemporary at no cost to the taxpayer.

3.2 The target market for the ESP

Existing ISA savers are the target market for ESPs. These fall into four sub-groups:

- those that are unaware of Junior ISAs owing to lack of government endorsement (unlike CTFs);
- those that are likely to be already aware of CTFs/Junior ISAs but may not have one in place owing to choice overload from providers;
- those that have CTFs/Junior ISAs in place but lack of confidence in designing and managing a suitable savings strategy. Of particular concern are those CTF holders who will want to migrate to Junior ISAs but are concerned by the relative lack of consumer protection under the Junior ISA regime;
- confident investors who enjoy managing CTFs/Junior ISAs on behalf of their children. This group is a minority. They will nonetheless be attracted to the ESP owing to the lower fee cap.

Investment providers would be the contractual counterparty to the ESP Junior ISA savers and would be typically stockbrokers or investment platforms who provide administration and custody. They would be responsible for communicating with savers and ensuring the investment options were appropriate to the ESP. Where used they would be responsible for ensuring that the investment strategy remains appropriate to the time horizon of expected withdrawals at 18.

Investment solutions could be a restricted range of low-cost funds and a personalised 'default option' similar to Automatic Enrolment and stakeholder Child Trust Funds. The default option can draw on existing guidance[15] and represent a diversified strategy delivered via a combination of funds that are switched using a 'lifestyling' process or Target Date Funds that deliver a similar 'lifestyling' process within a single fund. The proposed fee constraint of 1.00% necessarily means that combinations of passive funds into a suitable asset allocation are most likely.

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[15] Department for Work and Pensions *"Guidance for offering a default option for defined contribution automatic enrolment pension schemes"* 2011.

4. A SCHOLARSHIP AND BURSARY FUND

As part of being awarded a kitemark, administrative providers would undertake to provide a portion of their fees to a charitable trust to make donations to higher education establishments to sponsor bursaries and scholarships.

The charitable trust could be set up very simply and at no cost under the Charities Aid Foundation umbrella with the Chancellor acting as original donor (with an initial donation of £1). The Chancellor can then select a steering group of suitable candidates to oversee donations from the charitable trust to higher education establishments and other charities that promote financial inclusion, financial education and improved access to higher education. This trust could make donations to higher educational establishments to fund scholarships and bursaries to help the financially disadvantaged.

5. DRAWBACKS TO CHILD TRUST FUNDS

Child Trust Funds (CTF) have been successful in encouraging saving. The ESPs would build on this success with a similar motivation while offering the same protections that consumers value.[16]

According to a review by HM Treasury, factors determining the success of CTFs relative to other stakeholder products were 'marketing, the government contribution and the clear purpose for the accounts'.[17]

A key drawback to CTFs however has been their lack of profitability for providers. Responses to a government consultation cited the 'up front costs' of providing products as a reason why 'it took a number of years before profits were generated (one estimate suggested around 10 years).[18]

5.1 'Lifestyled' funds

A key reason for the lack of profitability was the stipulation that CTFs should be 'lifestyled', which imposed administrative costs as it involves switching funds. Providers suggested that 'changes could be made to the CTF rules to mitigate this impact, such as removing the requirement to 'lifestyle' CTF stakeholder accounts' and the 'removal of 'lifestyling' – which would result in reduced costs to providers and could produce improved growth for account holders'.[19] However providers also commented that 'the risk' that 'the removal of stakeholder features and protections' could lead to 'customer detriment'.[20]

5.2 The advantage of the ESP

ESPs would offer investors the same tax-incentivised benefits and consumer protection that they valued in CTFs but at a lower cost, owing to technological developments in the investment industry.

The lifestyling towards withdrawal date characteristic can either be achieved using administrative switching, or can now be achieved within the fund itself by using Target Date Funds. This characteristic simplifies the investment decision and the ongoing investment journey making them suitable as a default investment option for the National Employment Savings Trust (NEST). For the

16 HM Treasury *"Child Trust Fund: response to consultation"* 2013.

17 HM Treasury *"Sergeant Review: Simple financial products: a summary of consultation responses."* 2013.

18 HM Treasury *"Simple financial products: a consultation"* 2010.

19 HM Treasury *"Child Trust Fund: response to consultation"* 2013.

20 Ibid.

same reason, they are also used in college savings plans in the US.

Given the popularity of the protections that Child Trust Funds offered savers, the 'lifestyling' investment protection should be retained in guidance for ESPs whether using administrative switching or using Target Date Funds. However the overall Total Cost of Investing (as defined by the fund underlying OCF and any platform/administrative fee including switching) should be capped at 1.00% to reflect feedback regarding CTFs and technological advances by the investment industry.

6. CONCLUSION

The current system of promoting debt as the means to higher education should be reassessed. Upon graduating, students are faced with debts on average in excess of £40,000, which they will then spend much of their working lives paying off. It would be better for prospective students to be encouraged to finance their studies with savings.

Building on the success of the Junior ISA and Child Trust Funds, a new savings plan should be introduced: the Education Savings Plan. This will help to ensure that young people and their supporters are not discouraged by concerns over student debt and tuition fees from aspiring to higher education. A Scholarship and Bursary fund for the financially disadvantaged would also be created by providers of Education Savings Plans. This fund would contribute a portion of providers' fees into a pooled charitable trust to be used by universities and colleges to offer scholarships and bursaries to students unable to maximise contributions to their own Education Savings Plan.

CASE STUDY: *Saving for higher education in the US – College Savings Plans*

In the US, states offer tax incentivised savings plans for students to cover the costs of their higher education. One such plan is the *College Savings Plan*.

College Savings Plans

College Savings Plans are trust-based collective savings schemes administered by individual states. Deposits are made into an investment account which is free of federal tax. Withdrawals are also tax free if they are used to pay for higher education. Account holders are only permitted to change their investment option once per year and there is a maximum account balance. College Savings Plans are available both as 'direct sold' savings plans or 'adviser sold' plans with a wider range of investment options available via adviser sold plans. Most states offer tax incentives to encourage use of the savings plans. 10 states offer means-tested matching grants, in which the states match the contribution paid into the account.[21]

Incentives to save in College Savings Plans

A 2014 survey conducted by US public corporation Sallie Mae[22] sought to better understand how Americans save for their higher education. The survey asked respondents to select 2 of 18 *'features [that] were important to you when choosing a dedicated college savings plan'* the top responses included:

- 35% *Tax Benefits;*
- 20% *Knowing it was dedicated to college saving so I wouldn't be tempted to use the money for something else;*
- 19% *Low fees;*
- 18% *Low risk;*
- 12% *Investment in a fund that carries high return opportunity;*
- 11% *Age-based investment option which matures the year my child enters college;*
- 10% *Backed by state-government.*

21 Department of the Treasury *"An Analysis of Section 529 Plans College Savings and Prepaid tuition plans"* 2009.

22 Sallie Mae *"How America saves for college"* 2014.

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