House of Commons

Treasury Committee

Government Response to the Committee's Second Report on Child Trust Funds (HC 86)

First Special Report of Session 2003–04

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The Treasury Committee

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First Special Report

On 15 December 2003, the Treasury Committee published its Second Report, *Child Trust Funds*, as House of Commons Paper No. 86. We have now received a response from the Government (dated 10 February 2004) which is appended below.

APPENDIX: MEMORANDUM FROM HM TREASURY

The objectives of Child Trusts Funds

1. The Child Trust Fund is an ambitious, pioneering programme which seeks, through a significant long term investment by the Government, to provide a financial asset to all children when they reach the age of 18, and to change people's behaviour towards saving. Whilst those with higher income may make most use of the opportunity, we feel that this gives less well off families an unprecedented chance to build up a tax-free sum for their children. (Paragraph 21)

2. We note the Treasury's figures showing the potential significance of additional contributions from family and friends to the value of Child Trust Fund accounts at maturity. The Government is right to acknowledge the possibility that some families could lock away funds unwisely in Child Trust Fund accounts in the belief that this was in the best interests of their children. We therefore welcome the commitment to provide advice in both the information pack and promotional literature. We endorse the proposal to set out a hierarchy of savings objectives that promotes firstly paying off debt and secondly saving for a rainy day, ahead of any additional contributions to the Child Trust Fund. This information and advice needs to be clear and unambiguous. (Paragraph 22)

3. The Government has decided not to place any restrictions on the use of Child Trust Funds when they mature at age 18. We endorse the Government's hope that the funds will be spent on worthwhile projects, and acknowledge the practical difficulties of devising a scheme to ensure that this is the case. (Paragraph 23)

The Government thanks the Committee for recognising the objectives and opportunities afforded by the introduction of the Child Trust Fund (CTF).

The Government is working closely with interested parties, including the Financial Services Authority and groups with expertise in communicating with parents, to ensure that the information that we send to parents clearly outlines their options with respect to the CTF. This will be user tested to ensure that the messages are easily comprehensible and understandable.

Updated illustrative growth projections for the CTF (reflecting the announced charge cap of 1.5%) are available on the Inland Revenue website: http://www.ir.gov.uk/ctf. These supersede the previous projections set out in table 3.1 of the October 2003 paper *Detailed proposals for the Child Trust Fund.*

4. We note the Government's intention to monitor and publish regularly reports on the progress of the Child Trust Fund programme. We may wish to return to this subject in the light of the information these contain. (Paragraph 24)

The Government is developing an evaluation plan for the Child Trust Fund programme. The information we gather will be used to inform any future developments.

The first statistics on the Child Trust Fund will be available in 2007. These statistics will be extracted from returns financial providers make in September 2006. Up-dated statistics will be available annually from 2007.

Entitlement to a Child Trust Fund

5. We recognise that a cut-off date for entitlement to Child Trust Funds is required and consider that the choice of 1 September seems sensible. We note that the Government plans to recompense children born between 1 September 2002 and April 2005, when Child Trust Fund accounts are due to be available, for lost growth in their accounts by means of higher initial Government endowments, and that the additional amounts will be set out in regulations. (Paragraph 32)

The Government recognised the need to compensate children born between September 2002 and April 2005 for the lost growth in their accounts. The amounts were published with the regulations on 2 February 2004, and are as follows[1]:

All children born between 1 September 2002 and 5 April 2003:	£277
Supplement for this group:	£266
All children born between 6 April 2003 and 5 April 2004:	£268
Supplement for this group:	£258
All children born between 6 April 2004 and 5 April 2005:	£256

These figures are based on a real growth of 4.5%, nominal rate of about 7% assuming inflation of 2.5%, in accordance with FSA guidelines.

6. We consider that the natural reaction of parents with children born on either side of the cut-off date will be to try to see that they are treated equally. This may mean that those parents with sufficient financial resources will make additional provision for children who do not qualify for a Child Trust Fund account. We believe they would be encouraged to do this if Child Trust Fund accounts, identical in all respects save the absence of a Government endowment, were available for their other children. (Paragraph 33)

7. In the light of the evidence that the costs to the Treasury of the extra tax relief afforded by Child Trust Funds is negligible, we recommend that consideration be given

1 We separated children into 3 bands according to the tax year to reduce administration costs. For the initial payment, we calculated growth at the middle of each of these bands. For the supplement we took the April at the end of each band, which is when the supplement would normally be paid to the family (because a child tax credit award can only be finalised after the end of the relevant tax year).

to extending the availability of Child Trust Fund accounts but without Government endowments, to children born before 1 September 2002. (Paragraph 34)

The Government recognises that some parents will want to open similar accounts for older children and add their own endowment to the fund on a voluntary basis.

If the Government were to open accounts for all children born before 1 September 2002 but not provide a Government endowment for them, this would create some 10 million accounts with real uncertainty about the level of savings and investments that would be made in them. Such an exercise would be very costly for providers. The Government has looked carefully at this and at providing accounts only where they are requested by parents but it would not be possible for these to be up and running by April 2005 when providers would like them to be available to market alongside the CTF.

However, the Government is sure that if there is a gap in the market place the industry will provide equivalent products, perhaps with a charge cap and lifestyling facility that matches their Child Trust Fund products. Children have a personal tax allowance of £4,615 and a parent is taxed on a child's account only when his or her gift produces more than £100 gross income per year.

The Government will monitor the situation before and after the introduction of the CTF to establish if there is any evidence of an unmet demand in the marketplace.

Advice to parents

8. We support the proposal that simple, low cost, accessible and risk-controlled stakeholder Child Trust Fund accounts should be developed. We note the Government's firm preference that Child Trust Funds be invested in equity-based accounts on the grounds that these are likely to generate higher returns over the longer term than cash accounts. However, we also note that the potential for higher returns from equity based accounts is accompanied by a higher degree of risk that some families may not wish to face. We recommend that this be made clear to all parents in the information pack so that they can take into account their individual circumstances when deciding. If an easily understood risk evaluation can be designed, it should be provided with the information pack. (Paragraph 41)

The Government wants parents to engage actively with the Child Trust Fund and recognises that for many parents this will be their first investment decision. To ensure that we provide appropriate support for parents, the Government has commissioned research into the best way to communicate complicated financial and investment decisions. This will inform the information pack which will be sent to all parents alongside the voucher to open the account.

The Government is working closely with interested parties, including the Financial Services Authority and groups with expertise in communicating with parents to develop this information pack. The pack will include illustrations showing parents the impact of a range of investment choices and contribution levels on account growth, and the risks associated with these choices.

Revenue allocated accounts

9. We support steps to ensure that no child loses out from parents, or someone acting in that capacity, not opening a Child Trust Fund account on their behalf. In such cases the Revenue will open an equity based account and choose, albeit by rota, the provider to manage that account. We note the evidence from the Treasury and the Inland Revenue that they have obtained legal advice to the effect that in the event of any subsequent difficulties any accusations of mis-selling would be unsuccessful. (Paragraph 45)

The CTF Bill requires the Inland Revenue to open an account for children in three circumstances:

- For children whose voucher has not been used within a year of issue;
- For children looked after by local authorities for whom no Child Benefit award has ever been made and who would otherwise have no access to a Child Trust Fund; and
- For the children of parents under 16 who cannot by law administer a CTF account until they are 16.

In these circumstances draft regulations require the Revenue to apply to a provider to open a stakeholder account for the child. The draft regulations also set out that the Revenue will do this by rotating down a list of providers offering these accounts.

The CTF Bill states that there will be no liability for the Revenue in relation to the selection of account and of provider if these regulations are complied with.

The stakeholder account will be equity-based as this is likely to give the best return over 18 years, and the risk involved will be controlled with providers required to diversify investments and move them to cash-based assets as the fund nears maturity. In addition, the charge cap and the regulation surrounding minimum contributions on stakeholder accounts will ensure they provide value for money.

Interaction with the welfare system

10. There is a potential interaction of the Child Trust Fund with the welfare system (or any other entitlements that might be affected by possessing an asset) which might deter additional contributions to Child Trust Fund accounts from family and friends, if the result were to be a potential reduction in benefits for the child in the future, or an actual reduction in benefits for the contributor. (Paragraph 49)

11. The Government therefore needs to clarify the extent of this potential interaction, in order to overcome fears of potential disadvantage to the child in later life. We believe it is essential that this is done before the scheme starts, and we therefore welcome the statement by the Financial Secretary that this will be the case. We believe it would be helpful if these matters were clarified and resolved during the passage of the Bill through the House. (Paragraph 50)

Child Trust Fund assets and the income and gains from those assets do not impact on family benefits and tax credits before the account reaches maturity when the child reaches 18.

After the child's 18th birthday the account will cease to be a CTF account. The Government's intention is that when the CTF account matures, the funds can (if the account holder wishes) be rolled over into tax effective savings schemes available at the time. Income from investment in tax-free saving schemes do not affect entitlement to tax credits. But the Government acknowledges that there may be concern that saving in the Child Trust Fund or any other savings vehicle may affect entitlement to benefits such as Income Support when the individual is an adult.

The treatment of capital in income-related benefits needs to strike a sensible balance between providing targeted state support and not unfairly penalising those who have acted responsibly by saving. The Government will keep this under review. As a first step we announced during the second reading of the Bill that from 6 April 2006 we will increase the £3,000 threshold above which savings reduce eligibility to Income Support, Jobseeker's Allowance, Housing Benefit and Council Tax Benefit to £6,000 (in line with pension credit).

The Government also recognises there has been some concern about the application of capital deprivation rules with respect to the CTF.

Capital deprivation rules for income-related benefit, such as Pension Credit are designed as anti-abuse measures. The rules are needed to deal with cases where the real purpose in spending or otherwise disposing of savings is to get benefit or increase the amount of benefit payable. This places an unfair burden on taxpayers.

Whether payment into a CTF is treated as a deprivation of capital is a matter of judgement for the decision maker which will depend on all the circumstances of the case. But it would be reasonable to expect that in most cases it is unlikely that modest contributions to a CTF would be treated as deprivation of capital; the Pension Credit rules will be applied in a fair and consistent manner for CTF contributions and other payments.

Providing Child Trust Fund accounts

12. We consider that the success of Child Trust Funds will depend in part on attracting a wide range of providers. Whether sufficient providers enter the market will depend on the level of any charge cap and the regulatory regime that applies to Child Trust Funds, factors on which decisions are still awaited. (Paragraph 60)

13. We note that some key players have indicated that they are unlikely to provide Child Trust Funds if charges are capped at 1%. We consider that low charges will be important to ensure that adequate returns are generated from sums invested in Child Trust Funds. (Paragraph 61)

14. The Child Trust Funds Bill was introduced into the House without the relevant regulations covering important aspects including the proposed sales regime. We consider that these must be produced in time for the standing committee to consider them thoroughly. (Paragraph 62)

Draft regulations, published on 2 February, have set the level of the charge cap for stakeholder CTF accounts at 1.5% per year. The Government has set the charge cap to encourage a wide selection of providers to offer CTF accounts. A large number of providers will encourage competition, ensuring the best value for consumers. The Government will continue to monitor that the level of the charge cap best meets the interests of consumers.

The Government's decision was based upon all available evidence, and it recognised that the economics of the CTF are very different to the other stakeholder products. The CTF had certain key characteristics which were not typical of other products in the stakeholder suite, in particular CTF accounts will be smaller in terms of the average size of funds compared to pensions and will have a lower minimum contribution level than other stakeholder products.

The evidence base for the decision included the report commissioned by Deloitte, which analysed the trade-offs of different charge caps for providers and consumers. The research will be put into the public domain once a decision on the charge caps for the other stakeholder products has been made.

Research by the FSA has shown that the simplified sales regime they have been working on for stakeholder products needs further development. However, the CTF is likely to be less dependent on the simplified sales regime than the other stakeholder products. Many providers have said they intend to use direct offer as the main channel for selling the CTF. The Government will continue to work with the Financial Services Authority on the development of the sales regime for the CTF.

Conclusion

15. The Child Trust Fund programme has the potential to make a significant impact, particularly on people's attitude to saving. But the Government is committing itself and its successors to significant expenditure under this initiative, potentially over £4 billion over the next 18 years. It must therefore get the details of the scheme and its implementation right. (Paragraph 63)

The Child Trust Fund represents a new and imaginative way of encouraging children and their parents to save for the future, aided by an initial contribution from the Government for all children. The draft regulations published on 2 February 2004 set out in more detail how the scheme will work, including the charge cap. The Government looks forward to hearing the views of the financial services industry and other stakeholders and working with them to ensure the successful delivery of the CTF in 2005.

HM Treasury
10 February 2004

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* Government Responses are usually received in the same session as the Report was published. Accordingly, the HC number refers to that session unless otherwise indicated.